# SECURITIES AND EXCHANGE COMMISSION

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

MARY L. SCHAPIRO, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

(74 Documents)

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64374 / May 2, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3191 / May 2, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14360**

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| **In the Matter of**<br><br>**Aristeia Capital, LLC,**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act"), against Aristeia Capital, LLC ("Aristeia" or "Respondent").

## II.

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

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

III.

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

**Summary**

1. These proceedings arise out of violations of Rule 105 of Regulation M of the Exchange Act by Aristeia, a registered investment adviser and hedge fund manager located in New York, New York. Rule 105 prohibits buying an equity security made available through a public offering, conducted on a firm commitment basis, from an underwriter or broker or dealer participating in the offering after having sold short the same security during a restricted period (generally defined as five business days before the pricing of the offering).

2. On four occasions, from January through June 2008, Aristeia bought offered shares from an underwriter or broker or dealer participating in a follow-on public offering after having sold short the same security during the restricted period. These violations collectively resulted in profits of approximately $1.2 million.

**Respondent**

3. Aristeia is a Delaware limited liability company located in New York, New York. The firm has been registered voluntarily with the Commission as an investment adviser since 2005 and currently manages approximately $2.3 billion in investor assets.

4. During the relevant period, Aristeia managed two groups of hedge funds: onshore and offshore funds that followed convertible arbitrage, distressed debt and special situations investing strategies, and onshore and offshore funds that followed distressed debt and special situations strategies. Aristeia effected the trades that are the subject of these proceedings on behalf of funds that it managed. Although Aristeia managed multiple funds and employed several strategies, the trading at issue did not qualify for the "separate accounts" exception to Rule 105.

**Legal Framework**

5. As amended in 2007, Rule 105 of Regulation M provides in pertinent part:

> In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A . . . or Form 1-E . . . filed under the Securities Act of 1933 ("offered securities"), it shall be unlawful for any person to sell short . . . the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period ("Rule 105 restricted period") . . .

> [b]eginning five business days before the pricing of the offered securities and ending with such pricing . . . .

17 C.F.R. § 242.105(a); Short Selling in Connection with a Public Offering, Exchange Act Release No. 56206, 72 Fed. Reg. 45,094, 45,107 (Aug. 10, 2007)("Adopting Release").

6. Rule 105 applies irrespective of the short seller's intent in effectuating the short sale. "The prohibition on purchasing offered securities . . . provides a bright line demarcation of prohibited conduct consistent with the prophylactic nature of Regulation M." Adopting Release at 45,096. The Commission adopted Rule 105 in an effort to prevent manipulative short selling prior to a public offering and, therefore, "to foster secondary and follow-on offering prices that are determined by independent market dynamics . . ." Id. at 45,094.

**Aristeia's Violations of Rule 105 of Regulation M**

7. On January 14, 2008, Aristeia sold short 35,200 shares of convertible preferred stock of Thornburg Mortgage Inc. ("TMA"). Later that day, after the market closed, a follow-on offering of TMA convertible preferred stock was priced at $19.50 per share. Aristeia received an allocation of 750,000 shares in that offering. The difference between Aristeia's proceeds from the restricted period short sales of TMA convertible preferred shares and the price for 35,200 TMA convertible preferred shares purchased in the offering was $44,468. Aristeia also improperly obtained a benefit of $220,158 by purchasing the remaining 714,800 offering shares at a discount from TMA convertible preferred shares' market price.

8. On April 24, 28, and 29, 2008, Aristeia sold short a total of 60,300 shares of Citigroup Inc. On April 29, after the close of the market, Citigroup announced a follow-on stock offering. On April 30, 2008, before the market opened, the follow-on offering was priced at $25.27 per share. Aristeia received an allocation of 250,000 shares in that offering. The difference between Aristeia's proceeds from the restricted period short sales of Citigroup shares and the price for 60,300 Citigroup shares purchased in the offering was $65,664. Aristeia also improperly obtained a benefit of $32,249 by purchasing the remaining 189,700 offering shares at a discount from Citigroup shares' market price.

9. On June 17 and 18, 2008, Aristeia sold short 45,000 shares of Energy Conversion Devices Inc. After the market closed on June 18, 2008, a follow-on offering of Energy Conversion shares was priced at $72. The offering had two components: one component involved the issuer's loan of shares to the underwriters to facilitate the creation of hedging short stock positions for participants in a concurrent convertible debt offering. The other component was a capital raising offering, which was conducted on a firm commitment basis. Aristeia participated in both components; its purchase of 75,000 shares in the capital raising component violated Rule 105. The difference between Aristeia's proceeds from the restricted period short sales of Energy Conversion stock and the price for the 45,000 Energy Conversion shares purchased in the capital raising offering was $115,350. Aristeia also improperly obtained a benefit of $62,400 by purchasing the remaining 30,000 shares in the capital raising offering at a discount from Energy Conversion shares' market price.

10. On June 20 and June 23, 2008, Aristeia sold short a total of 203,000 shares of CapitalSource Inc. After the market closed on June 23, 2008, a follow-on offering of CapitalSource shares was priced at $11.00. Aristeia received an allocation of 1.2 million shares in that offering. The difference between Aristeia's proceeds from the restricted period short sales of CapitalSource stock and the price for 203,000 CapitalSource shares purchased in the offering was $396,140. Aristeia also improperly obtained a benefit of $285,142 by purchasing the remaining 997,000 offering shares at a discount from CapitalSource shares' market price.

11. In total, Aristeia's violations of Rule 105 resulted in profits of $1,221,571.

**Violations**

12. As a result of the conduct described above, Aristeia willfully[1] violated Rule 105 of Regulation M under the Exchange Act.

**Aristeia's Remedial Efforts**

13. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Aristeia and cooperation it 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 Respondent's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M under the Exchange Act.

B. Respondent is censured.

C. Respondent shall, within thirty (30) days of the entry of this Order, pay a civil penalty of $400,000, disgorgement of $1,221,571, and prejudgment interest of $141,205 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. § 3717. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order;

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1 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)).

(B) made payable to the Securities and Exchange Commission; (C) hand-delivered, wired, or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F Street, N.E., Mail Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Aristeia as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order, wire transfer, or check shall be sent to Andrew M. Calamari, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, N.Y. 10281.

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. 64377 / May 2, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3192 / May 2, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14362

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| In the Matter of<br><br>LAWRENCE R. GOLDFARB,<br><br>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 Lawrence R. Goldfarb ("Respondent").

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## II.

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

## III.

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

1. Goldfarb from 2005 through the present was the sole active managing member of Baystar Capital Management, LLC ("Baystar Capital Management"), which served as the investment adviser to Baystar Capital II, L.P. ("Baystar II"), a hedge fund. Baystar Capital Management was not registered with the Commission. According to FINRA's Web CRD database, Goldfarb from January 2008 through January 2009 was associated with a broker-dealer registered with the Commission. Goldfarb, 52 years old, is a resident of San Anselmo, California.

2. On March 16, 2011, a final judgment was entered by consent against Goldfarb, permanently enjoining him from future violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, in the civil action entitled Securities and Exchange Commission v. Lawrence R. Goldfarb and Baystar Capital Management, LLC, Civil Action Number CV-11-0938 WHA, in the United States District Court for the Northern District of California.

3. The Commission's complaint, the allegations of which Goldfarb neither admits nor denies, alleges that from 2006 to August 2010, Goldfarb employed a device, scheme, or artifice to defraud by failing to disclose and distribute to investors the proceeds from a profitable side pocket investment. It further alleges that rather than return the proceeds to investors, Goldfarb instead used the funds to make new investments by way of other entities in which he had a significant interest. According to the Commission's complaint, these new investments were not disclosed to the fund's investors until August 2010.

## IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Goldfarb be, and hereby is, barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, and from participating in any offering of penny stock, with the right to reapply for association after 5 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. 64379 / May 3, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14363

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| In the Matter of<br><br>Advanced Refractive Technologies, Inc.,<br>Bluebook International Holding Co. (The),<br>CBCom, Inc.,<br>Gener8xion Entertainment, Inc.,<br>Group Long Distance Inc.,<br>HiEnergy Technologies, Inc., and<br>Holter Technologies Holding, A.G.<br>(n/k/a International Consortium Corp.) and<br>Inchorus Com<br>(a/k/a Inchorus.Com, Inc.,<br>n/k/a WorldSource, Inc.),<br><br>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 Advanced Refractive Technologies, Inc., Bluebook International Holding Co. (The), CBCom, Inc., Gener8xion Entertainment, Inc., Group Long Distance Inc., HiEnergy Technologies, Inc., Holter Technologies Holding, A.G. (n/k/a International Consortium Corp.), and Inchorus Com (a/k/a Inchorus.Com, Inc., n/k/a WorldSource, Inc.).

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## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Advanced Refractive Technologies, Inc. ("ARFR") [1] (CIK No. 1082249) is a void a void Delaware corporation located in San Clemente, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ARFR 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 $5,713,620 for the prior nine months. As of April 26, 2011, the common stock of ARFR was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Bluebook International Holding Co. (The) ("BBKH") (CIK No. 1126577) is a void Delaware corporation located in Lake Forest, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BBKH 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, 2005, which reported a net loss of $2,711,273 for the prior year. As of April 26, 2011, the common stock of BBKH 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. CBCom, Inc. ("CBCI") (CIK No. 1129248) is a void Delaware corporation located in Encino, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CBCI 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 $904,446 for the prior nine months. As of April 26, 2011, the common stock of CBCI was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Gener8xion Entertainment, Inc. ("GNXE") (CIK No. 803034) is a void Delaware corporation located in Hollywood, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GNXE 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, 2008, which reported a net loss of $1,706,449 for the prior six months. As of April 26, 2011, the common stock of GNXE 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. Group Long Distance Inc. ("GLDI") (CIK No. 1004570) is a dissolved Florida corporation located in Irvine, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GLDI is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended July 31, 2001, which reported a net loss of $1,079,370 for the prior three months. As of

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

April 26, 2011, the common stock of GLDI was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. HiEnergy Technologies, Inc. ("HIET") (CIK No. 1112424) is a delinquent Delaware corporation located in Irvine, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). HIET is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended October 31, 2006, which reported a net loss of $3,982,329 for the prior six months. On May 14, 2007, HIET filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Central District of California, which was still pending as of April 26, 2011. As of April 26, 2011, the common stock of HIET was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. Holter Technologies Holding, A.G. (n/k/a International Consortium Corp.) ("ICSM") (CIK No. 1095232) is a revoked Nevada corporation located in Calabasas, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ICSM is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000. As of April 26, 2011, the common stock of ICSM was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

8. Inchorus Com (a/k/a Inchorus.Com, Inc., n/k/a WorldSource, Inc.) ("WDSC") (CIK No. 1094641) is a defaulted Nevada corporation located in Burbank, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). WDSC 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 December 31, 2000, which reported a net loss of $3,758,100 for the prior nine months. As of April 26, 2011, the common stock of WDSC was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

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

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

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

## III.

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

A. Whether the allegations contained in Section II 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**
**May 3, 2011**

**In the Matter of**

**Advanced Refractive Technologies, Inc.,**
**Bluebook International Holding Co. (The),**
**CBCom, Inc.,**
**Gener8xion Entertainment, Inc.,**
**Group Long Distance Inc.,**
**HiEnergy Technologies, Inc., and**
**Holter Technologies Holding, A.G.**
**(n/k/a International Consortium 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 Advanced Refractive Technologies, 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 Bluebook International Holding Co. (The) because it has not filed any periodic reports since the period ended December 31, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of CBCom, Inc. because it has not filed any periodic reports since the period ended September 30, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Gener8xion Entertainment, Inc. because it has not filed any periodic reports since the period ended April 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Group Long Distance Inc. because it has not filed any periodic reports since the period ended July 31, 2001.

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Holter Technologies Holding, A.G. (n/k/a International Consortium Corp.) because it has not filed any periodic reports since the period ended September 30, 2000.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on May 3, 2011, through 11:59 p.m. EDT on May 16, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter
Commissioner Aguilar
not participating

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64380 / May 3, 2011**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3274 / May 3, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14364**

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| **In the Matter of**<br><br>**Rockwell Automation, Inc.**<br><br>**Respondent.** | **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 that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Rockwell Automation, Inc. ("Rockwell" 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 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 Respondent's Offer, the Commission finds[1] that:

**Summary**

1. This matter involves violations of the books and records and internal controls provisions of the Foreign Corrupt Practices Act ("FCPA") by Rockwell, through one of its former subsidiaries in China, Rockwell Automation Power Systems (Shanghai) Ltd. ("RAPS-China"), which was divested by Rockwell in January, 2007.

2. From 2003 to 2006, certain employees of RAPS-China paid approximately $615,000 to Design Institutes, which were typically state-owned enterprises that provided design engineering and technical integration services that can influence contract awards by end-user state-owned customers. The payments were made through third-party intermediaries at the request of Design Institute employees and at the direction of RAPS-China's Marketing and Sales Director. RAPS-China's Marketing and Sales Director intended that these funds be paid directly to the Design Institute employees, with the expectation that they would influence the ultimate state-owned customers to purchase RAPS products. While the Design Institutes did provide some bona fide engineering and other services in connection with RAPS-China's end-user contracts, RAPS-China could not substantiate the specific services rendered or the value of those services. Also during the same period, employees of RAPS-China paid approximately $450,000 to fund sightseeing and other non-business trips for employees of Design Institutes and other state-owned companies.

3. Rockwell realized approximately $1.7 million in net profits on sales contracts with end-user Chinese government-owned companies that were associated with payments to the Design Institutes.

4. Rockwell failed to accurately record the payments in its books and records, and failed to implement or maintain a system of internal accounting controls sufficient to prevent and detect the payments.

**Respondent**

5. Rockwell is a global company engaged in the design and manufacture of industrial automation products and services. The company is incorporated in Delaware and has its principal executive offices in Milwaukee, Wisconsin. Rockwell's common stock is registered with

[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 Commission pursuant to Section 12(b) of the Exchange Act and is listed on the New York Stock Exchange.

## Other Related Entities

6. RAPS-China was a wholly-owned subsidiary of Rockwell, headquartered in Shanghai, China. In 2007, in connection with the sale of its former Power Systems business, Rockwell sold RAPS-China to Baldor Electric Company. RAPS-China supplied industrial mechanical power transmission products and industrial motors and drives.

## Facts

### A. RAPS-China Paid Design Institutes Through Third-Party Intermediaries

7. During 2003, RAPS-China opened a manufacturing facility in Shanghai. Among other products, RAPS manufactured a Controlled Start Transmission ("CST"), which is used in the mining industry. The CST product was sold by RAPS-China primarily to Chinese government-owned coal mining and processing plants.

8. Design Institutes had an influence on the Chinese government-owned mining companies to which RAPS-China sought to sell its CST product due to their expertise in the engineering of systems that included the CST product. Between 2003 and 2006, payments were made to Design Institutes in connection with certain CST sales contracts ("DI Payments").

9. RAPS-China made the DI Payments through third-party intermediaries.

10. In all, RAPS-China made approximately $615,000 in DI Payments during the period 2003 to 2006. Although the Design Institutes supplied RAPS-China with bona fide technical and engineering services, the RAPS-China Marketing and Sales Director also intended the payments to influence sales contracts with end-user Chinese government-owned companies.

11. RAPS-China recorded the DI Payments as "cost of sales."

### B. RAPS-China Funded Leisure Travel for State-Owned Customers and Design Institute Employees

12. RAPS-China funded travel, including some leisure travel not directly related to legitimate business purposes, for employees of Design Institutes and other Chinese government-owned companies to the U.S., Germany and Australia, among other locations. Destinations in the U.S. included New York City, Washington D.C., and Hawaii. These leisure trips typically followed business-related travel that was also funded by RAPS-China.

13. Some trips appeared to have no direct business component, other than the development of customer good will. For example, RAPS-China arranged for so-called design

meetings in New York City despite the lack of any Rockwell facility there because "everyone likes New York."

14. From 2003 to 2006, employees of RAPS-China paid approximately $450,000 to fund trips not directly related to business purposes for employees of Design Institutes and state-owned customers. These trips were recorded in Rockwell's books and records as business expenses, without any designation that there were reasons not directly connected to the negotiation or execution of contracts or to the promotion of the company's products.

## C. Discovery, Self-Reporting and Remediation

15. Rockwell discovered the DI Payments and the third-party payment mechanism in 2006 through its normal financial review process. This process was part of Rockwell's global corporate compliance/internal controls program, which had targeted China for enhanced FCPA training and scrutiny starting in 2004. Upon discovery of the issue, Rockwell hired counsel and investigated the DI Payments with the oversight of its Board of Directors. It voluntarily self-reported the DI Payments to the Commission and voluntarily provided the Commission Staff with all relevant facts found in the investigation, and otherwise cooperated with the Commission. As a result of the discovery of this matter, Rockwell undertook numerous remedial measures, including employee termination and disciplinary actions, enhancements to its internal controls and compliance program and conducted a broad, global review of its other operations.

## Violations

16. The FCPA, enacted in 1977, added Exchange Act Section 13(b)(2)(A) to require public companies 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. It also added Exchange Act Section 13(b)(2)(B) to require such companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions: (i) are executed in accordance with management's general or specific authorization; and (ii) are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets. 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

17. In connection with the payments described above, Rockwell failed to make and keep accurate books, records and accounts as required by Section 13(b)(2)(A) of the Exchange Act, and thereby violated Section 13(b)(2)(A).

18. Further, as evidenced by the DI Payments (as described above) and leisure travel payments, Rockwell failed to devise or maintain sufficient internal controls as required by Section 13(b)(2)(B) of the Exchange Act, and thereby violated Section 13(b)(2)(B).

## IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Rockwell cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

B. Respondent shall, within 14 days of the entry of this Order, pay disgorgement of $1,771,000, prejudgment interest of $590,091 and a civil money penalty of $400,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 USC 3717. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, 100 F Street, NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Rockwell 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 Cheryl Scarboro, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-5561.

C. Respondent acknowledges that the Commission is not imposing a civil penalty in excess of $400,000 based upon its cooperation in a Commission investigation. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and without prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay an additional civil penalty. Respondent may not, by way of defense to any resulting administrative proceeding: (1) contest the findings in the Order; or (2) 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. 64384 / May 3, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14366**

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| **In the Matter of**<br><br>**Columbia Futures Fund,**<br>**Computer Power, Inc.,**<br>**Concept Digital, Inc.,**<br>**Connectivity Technologies, Inc.,**<br>**Constellation 3D, Inc.,**<br>**Construction Technology Industries, Inc., and**<br>**Continuum Group A, Inc.,**<br><br>**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 Columbia Futures Fund, Computer Power, Inc., Concept Digital, Inc., Connectivity Technologies, Inc., Constellation 3D, Inc., Construction Technology Industries, Inc., and Continuum Group A, Inc.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Columbia Futures Fund (CIK No. 701286) is a New York limited partnership located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Columbia Futures Fund is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2002.

2. Computer Power, Inc. (CIK No. 792986) is a New Jersey corporation located in High Bridge, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Computer Power 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, 1999, which reported a net loss of over $42,000 for the prior nine months. On July 10, 2001, Computer Power filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of New Jersey, which was terminated on February 6, 2006.

3. Concept Digital, Inc. (CIK No. 1128724) is a Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Concept Digital 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 over $81,000 for the prior nine months.

4. Connectivity Technologies, Inc. (CIK No. 714399) 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). Connectivity Technologies is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 1999, which reported a net loss of over $2 million for the prior twelve months.

5. Constellation 3D, Inc. (CIK No. 1080290) is a forfeited Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Constellation 3D is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K/A for the period ended December 31, 2000, which reported a net loss of over $20 million for the prior twelve months. On December 13, 2002, Constellation 3D filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of New York, which was terminated on June 12, 2006.

6. Construction Technology Industries, Inc. (CIK No. 748092) is a void Delaware corporation located in Harrington Park, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Construction Technology Industries is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB Registration Statement on March 30, 2000.

7. Continuum Group A, Inc. (CIK No. 1272548) is a revoked Nevada corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Continuum Group A 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 March 31, 2004, which reported a net loss of $4,000 for the prior three months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

**III.**

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

A. Whether the allegations contained in Section II 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. 64385 / May 3, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14365**

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| **In the Matter of**<br><br>**Comedco, Inc.,**<br>**Communications/USA, Inc.,**<br>**Complete Wellness Centers, Inc.,**<br>**Consolidated Resources Group, Inc.,**<br>**Consolidated Stainless, Inc., and**<br>**Conus Holdings, Inc.,**<br><br>**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 Comedco, Inc., Communications/USA, Inc., Complete Wellness Centers, Inc., Consolidated Resources Group, Inc., Consolidated Stainless, Inc., and Conus Holdings, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Comedco, Inc. (CIK No. 217330) is a forfeited Delaware corporation located in Boca Raton, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Comedco 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 December 31, 1995.

2. Communications/USA, Inc. (CIK No. 1001270) is a dissolved Florida corporation located in Clearwater, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Communications/USA 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, 1996, which reported a net loss of over $98,000 for the prior twelve months.

3. Complete Wellness Centers, Inc. (CIK No. 1022828) is a forfeited Delaware corporation located in Winter Park, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Complete Wellness is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000, which reported a net loss of over $4.3 million for the prior nine months.

4. Consolidated Resources Group, Inc. (CIK No. 1093509) is a Florida corporation located in Delray Beach, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated Resources Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended February 28, 2002, which reported a net loss of over $148,000 for the prior three months.

5. Consolidated Stainless, Inc. (CIK No. 909726) is a void Delaware corporation located in Orlando, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated Stainless 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 $5 million for the prior six months. On December 15, 1997, Consolidated Stainless filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, which was converted to Chapter 7, and was terminated on February 23, 2011.

6. Conus Holdings, Inc. (CIK No. 1106206) is a permanently revoked Nevada corporation located in Tampa, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Conus 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 $20,000 for the prior three months.

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.

9. 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
ECURITIES AND EXCHANGE COMMISSION

NGE ACT OF 1934
lay 3, 2011

SEC AUDITING ENFORCEMENT
Re lay 3, 2011

PROCEEDING

A

: ORDER GRANTING APPLICATION FOR
: REINSTATEMENT TO APPEAR AND PRACTICE
: BEFORE THE COMMISSION AS AN ACCOUNTANT
: RESPONSIBLE FOR THE PREPARATION OR
: REVIEW OF FINANCIAL STATEMENTS REQUIRED
: TO BE FILED WITH THE COMMISSION

On March 30, 2006, Aron R. Carr, CPA ("Carr") was denied the privilege of appearing or practicing before the Commission as an accountant as a result of settled public administrative proceedings instituted by the Commission against Carr pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[1] Carr consented to the entry of the order without admitting or denying the findings therein. This order is issued in response to Carr's application for reinstatement to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

The Commission found that Carr engaged in improper professional conduct within the meaning or Rule 102(e)(1)(ii) of the Commission's Rules of Practice while serving as a senior auditor on the FY 2002 audit of Tenet Healthcare Corporation ("Tenet") performed by KPMG LLP. Specifically, by modifying and creating workpapers without appropriate supplemental documentation after the issuance of the audit report, Carr engaged in highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which he knew, or should have know, that heightened scrutiny was warranted.

In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Carr attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while

[1] *See* Accounting and Auditing Enforcement Release No. 2405 dated March 30, 2006. Carr was permitted, pursuant to the order, to apply for reinstatement after three years upon making certain showings.

practicing before the Commission in this capacity. Carr is not, at this time, seeking to appear or practice before the Commission as an independent accountant. If he should wish to resume appearing and practicing before the Commission as an independent accountant, he will be required to submit an application to the Commission showing that he has complied and will comply with the terms of the original suspension order in this regard. Therefore, Carr's suspension from practice before the Commission as an independent accountant continues in effect until the Commission determines that a sufficient showing has been made in this regard in accordance with the terms of the original suspension order.

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

On the basis of information supplied, representations made, and undertakings agreed to by Carr, it appears that he has complied with the terms of the March 30, 2006 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Carr, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, has shown good cause for reinstatement. Therefore, it is accordingly,

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Aron R. Carr, CPA is hereby reinstated to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

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

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[2] Rule 102(e)(5)(i) provides:

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

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-64383; File No. 4-627]

**Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2)**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Request for comment.

**SUMMARY:** The Securities and Exchange Commission ("Commission"), on behalf of its Division of Risk, Strategy, and Financial Innovation ("Division"), is requesting public comment with regard to studies required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of the feasibility, benefits, and costs of requiring reporting in real time, either publicly or, in the alternative, only to the Commission and the Financial Industry Regulatory Authority ("FINRA"), of short sale positions of publicly listed securities, and of conducting a voluntary pilot program in which public companies would agree to have all trades of their shares marked "long," "short," "market maker short," "buy," or "buy-to-cover," and reported as such in real time through the Consolidated Tape.

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

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-627 on the subject line.

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Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number 4-627. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov). Comments will also be 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 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Amy Edwards, Assistant Director, Bruce Kraus, Co-Chief Counsel, Lillian Hagen, Special Counsel, Sandra Mortal, Financial Economist, Division of Risk, Strategy, and Financial Innovation, at (202) 551-6655, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-4977.

**DISCUSSION:**

Under Section 417(a)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act),[1] the Commission's Division of Risk, Strategy, and Financial Innovation is required to conduct studies of the feasibility, benefits, and costs of (A) requiring reporting in real time, publicly or, in the alternative, only to the Commission and the Financial Industry Regulatory Authority, short sale positions in publicly listed securities, and (B) conducting a voluntary pilot program in which public companies could agree to have sales of their shares marked "long," "short," or "market maker short," and purchases of their shares

[1] Pub. L. No. 111-203 (July 21, 2010).

marked "buy" or "buy-to-cover," and reported as such in real time through the Consolidated Tape.[2]

In the Division's estimation, data made public by certain self-regulatory organizations ("SROs") indicate that orders marked "short" under current regulations account for nearly 50% of listed equity share volume.[3] Short selling involves a sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.[4] Typically, the short seller later closes out the position by purchasing equivalent securities on the open market and returning the security to the lender.[5] In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security.[6]

To better inform the study required by Section 417(a)(2) of the Dodd-Frank Act, the Commission, on behalf of the Division, seeks comment on both the existing uses of short selling in securities markets and the adequacy or inadequacy of currently available information

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[2] The term "Consolidated Tape," as used throughout this release, refers to the current reporting systems for transactions in all exchange-listed stocks and ETFs. These systems include Tapes A and B of the Consolidated Tape Plan and Tape C of the Unlisted Trading Privileges or "UTP" Plan. Trades in New York Stock Exchange ("NYSE") -listed securities are reported to Tape A; trades in NYSE-Amex, NYSE-Arca, and regional exchange-listed securities are reported to Tape B; and trades in NASDAQ-listed securities are reported to Tape C. Transactions in unlisted equities, options, or non-equity securities are not currently reported to the Consolidated Tape. For more information see http://www.nyxdata.com/cta and http://www.utpplan.com/.

[3] This estimate was made by the Division based on short selling volume data for June 2010 made available by SROs. This estimate is consistent with estimates for prior months, and the short percentage varied little from day to day. The underlying data can be found at hyperlinks available at http://www.sec.gov/answers/shortsalevolume.htm, and have been provided since August 2009 by the SROs listed therein. As indicated on these hyperlinks, "short selling volume" is the volume of executed orders marked "short" or "short exempt" pursuant to Rule 200(g) of Regulation SHO (which requires broker-dealers to mark all equity sell orders as either "long," "short," or "short-exempt"). See 17 CFR 242.200(g). Under current rules, these order marks are not submitted to or reported on the Consolidated Tape, but are maintained as part of broker-dealers' books and records pursuant to Rules 17a-3 and 17a-4. See 17 CFR 240.17a-3(a)(5)-(7) and 240.17a-4(b)(8).

[4] See 17 CFR 242.200(a).

[5] See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) ("Regulation SHO Adopting Release"), available at http://www.sec.gov/rules/final/34-50103.htm.

[6] See, e.g., id.

regarding short sales, as well as comment on the likely effect of these possible future reporting regimes on the securities markets, including their feasibility, benefits, and costs.

The Commission is required to submit a report on the results of these studies to Congress no later than July 21, 2011. All interested parties are invited to submit their views, in writing. Empirical evidence relevant to any part of the Division's study is expressly requested.

## I. Baseline

Certain information regarding short sales is currently available to the public. This information includes the total "short interest" in each listed security (*i.e.*, total shares in short positions in that security in all customer and proprietary firm accounts of FINRA member firms), which has been reported twice each month since 2007,[7] as well as data made available more recently on the short selling volume for each listed equity security that is reported on a daily basis,[8] and trade-by-trade short sale transaction data that is released on a delayed (no more than 30 days after the end of the month) basis.[9] Additionally, certain data vendors offer stock lending data, including stock loan volume, lending costs, and the percentage of available stock out on loan, which some market commentators have used as measures of short selling.[10] Further, Section 929X(a) of the Dodd-Frank Act amended Section 13(f) of the Securities Exchange Act

[7] See FINRA Rule 4560. FINRA member firms must report total shares in short positions in all of their customer and proprietary firm accounts in all equity securities twice per month through FINRA's web-based Regulation Filing Application ("RFA") system. The short interest data in listed stocks is released by exchanges that list those stocks. Further, FINRA releases the short interest data in unlisted stocks.

[8] See supra note 3 for more information on this data and how to obtain it.

[9] These data sets include one observation for each execution involving a short sale and typically date from August 2009. These data sets can be found at hyperlinks available at http://www.sec.gov/answers/shortsalevolume.htm.

[10] Data Explorers and SunGard, for example, provide data on securities lending to clients. As some commentators have noted, stock lending facilitates short selling (see, e.g., Speech by Chester Spatt, available at http://www.sec.gov/news/speech/2007/spch042007css.htm). As noted above, a number of data vendors sell information as to shares that have been loaned to other investors. Among other things, this information may include volume of loans, lending costs, and the percentage of available stock out on loan. This data offers indirect evidence of short selling, and some research has used stock lending data as a proxy for actual short sales. See, e.g., Oliver Wyman, "The effects of short selling public disclosure of individual positions on equity markets" (Feb. 2011), available at http://www.oliverwyman.com/ow/pdf_files/OW_EN_FS_Publ_2011_Short_Selling_Public_Disclosure_Equity_Markets.pdf.

of 1934 ("Exchange Act") to require the Commission to adopt rules requiring monthly (or potentially more frequent) public short sale disclosures by security, including the "aggregate amount of the number of short sales of each security, and any additional information determined by the Commission."[11]

Q1. How are currently available data used by issuers, market participants, and others (such as SROs, data vendors, media, analysts, and academics) today? How widely distributed are currently available data? Do costs or other factors limit access to currently available data? Are there other important sources of information as to short sales and short sale positions in addition to those mentioned above?

Q2. The Division understands that equity market makers rely on short selling to facilitate customer buy orders and to ensure that they can maintain two-sided markets without carrying large risky positions. The Division also understands that option market makers frequently sell short to hedge positions taken in the course of market making activities.[12] Why else might market makers sell short? How much of all short selling is accounted for by bona fide market making? Do market makers sell short for purposes other than bona fide market making?[13] Are there ways in which short sales by market makers and other market participants performing similar roles or functions (but that are not subject to some or all of the requirements applicable to market makers) could be viewed as problematic?

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[11] See Exchange Act Section 13(f)(2), as amended.

[12] See, e.g., Exchange Act Release No. 58775 (Oct. 14, 2008), 73 FR 61690 (Oct. 17, 2008).

[13] In adopting Regulation SHO, the Commission discussed several activities that are not bona fide market making. Specifically, the Commission stated bona fide market making: (1) "does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security"; (2) "where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona fide market making for purposes of the exception"; and (3) "does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with Rule 203(b)(1) by the other broker-dealer or customer." Exchange Act Release No. 50103, 69 FR 48008, 48015 (Aug. 6, 2004) (citations omitted).

Q3. The Commission requests comment on the ways and the extent to which, if any, commenters believe that short selling has been associated with abusive market practices, such as "bear raids" where an equity security is sold short in an effort to drive down the security's price by creating an imbalance of sell-side interest?[14] In addition, the Commission requests comment on the ways and extent to which, if any, commenters believe trade-based manipulation (i.e., manipulating without a corporate action or spreading false information)[15] using short sales is possible? Would greater transparency of short positions or short sale transactions help to better deter or prevent such abuses, or assist in additional appropriate actions to prevent them? If so, what new disclosures should be required?

## II. Position Reporting

Section 417(a)(2)(A) of the Dodd-Frank Act requires the Division to conduct a study of short "position" reporting; the term "position" is not defined in the Exchange Act or in Section 417 of the Dodd-Frank Act. For purposes of this study, the Division plans to use "position" to refer to outstanding holdings at a point in time. Further, Section 417 of the Dodd-Frank Act does not specify a particular level of aggregation and netting, address whose positions would be reported, or indicate whether derivatives or other ways to obtain economic exposure to a stock are covered and existing U.S. regulatory definitions vary in this dimension.[16] "Economic exposure" as used by the Division in this request for comment refers to any financial interest in a

[14] See, e.g., Exchange Act Release No. 61595 (Feb. 26, 2010), 75 FR 11232, 11235 (Mar. 10, 2010).
[15] For a discussion of the theory regarding trade based manipulation, See Allen, F. and D. Gale, "Stock Price Manipulation," (1992) *Review of Financial Studies*, 5(3), 503-529.
[16] FINRA defines a short position as resulting from "short sales" as that term is defined in Rule 200(a) of Regulation SHO, but captures the position as of a settlement date as opposed to a trading date. See FINRA Rule 4560. The Commission defined a short selling position in former Rule 10a3-T as "the aggregate gross short sales of an issuer's Section 13(f) securities (excluding options), less purchases to close out a short sale in the same issuer," and stated that "the Form SH short position is not net of long position." See Exchange Act Release No. 58785 (Oct. 15, 2008), 73 FR 61678 (Oct. 17, 2008). The reporting requirements of Form SH were in effect from September 22, 2008 to August 1, 2009.

company, however acquired. For example, an investor may have economic exposure to a company by owning the stock itself, or through ownership of an index or of derivatives. Likewise, the short sale position reporting requirements in foreign jurisdictions, implemented or proposed, differ from one another in a number of areas with respect to the definition of "position," including inclusion or exclusion of derivatives in the short interest calculation, and reporting of net or gross position. For example, the short interest calculation in Australia[17] and Hong Kong[18] does not or would not include derivatives, whereas the U.K.[19] and a proposal by the European Union (the "E.U. Proposal")[20] both include or would include them. In Australia,[21] the E.U. Proposal,[22] and the U.K.,[23] the reportable position is or would be the *net* short position, while in Hong Kong, long interest and short positions are calculated separately and are not netted.[24]

Q4. Would real time reporting of the short positions of all investors, intermediaries, and market participants be feasible, and if so, in what ways would it be beneficial? What problems would it address? What would be any reasons, in terms of benefits and costs, for treating short sale position reporting differently than long position reporting? Would "real time" reporting be necessary to achieve these benefits, or is "prompt" updating for

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[17] See Corporations Regulations 2001 (Commonwealth), regulation 7.9.99(2) (Australia), indicating that the short interest calculation includes securities, managed investment products, and sovereign debentures, stocks or bonds.

[18] See Hong Kong Securities and Futures Commission, Consultation Conclusions on Increasing Short Position Transparency (Mar. 2, 2010), available at http://www.sfc.hk/sfc/doc/EN/speeches/consult/consultationconclusion2march2010english.pdf.

[19] Short Selling Rules, 2010, FINMAR 2010 (U.K.), ¶ 2.3.6.

[20] The Committee for European Securities Regulators ("CESR") proposed to require that positions be netted at the legal entity level and include all financial instruments that create economic exposure to an issue. See CESR, Model for a Pan-European Short Selling Disclosure Regime, CESR/10-088 (Mar. 2010) ("E.U. Model"), at 9.

[21] See Corporations Regulations 2001 regulation 7.9.99 (Australia), which states that "a short position is short sales net of long positions."

[22] E.U. Model, at 9.

[23] FINMAR (U.K.), at ¶ 2.3.2.

[24] See Hong Kong Securities and Futures Commission, Consultation Conclusions on Increasing Short Position Transparency (Mar. 2, 2010), available at http://www.sfc.hk/sfc/doc/EN/speeches/consult/consultationconclusion2march2010english.pdf.

material changes in the short position (such as Schedule 13D updating requirements) sufficient?[25] If real time reporting would be beneficial, should "real time" be defined as "continuously updated as soon as practicable," or as frequent "snapshots" of short positions throughout the trading day? Should "as soon as practicable" be defined and, if so, how? If frequent short sale position reporting of some kind would be beneficial, how frequently should such reports be made in order to realize those benefits? Would real time data be more or less accurate than data reported on a delay? Please explain why or why not.

Q5. Who would be likely to use real time short position data, and how? Would the short sale position data be too voluminous to be used directly by investors? Could such data help to detect more easily, better deter, or better prevent short selling abuses? Would market commentators and others use real time short position data to help the public better understand the U.S. securities markets? Would users of real time short position data be able to derive reasonably clear interpretations of the data in real time, and, to the extent they could not, how would the costs and benefits of any reporting regime be affected? Would real time data on short positions help or hinder long-term investors in making "efficient investments?"[26]

Q6. How would real time data on short positions affect the behavior of short sellers and other investors? Would it affect abusive short selling, in particular? To what extent, if any,

[25] Exchange Act Rule 13d-2 requires that if there is any material change in the facts set forth in a Schedule 13D, including, but not limited to, any material increase or decrease in the percentage of the class beneficially owned, the person required to file the statement must promptly file an amendment disclosing the change. See 17 CFR 240.13d-2.

[26] See, e.g., Biagio Bossone, Sandeep Mahajan, and Farah Zahir, *Financial Infrastructure, Group Interests, and Capital Formation* (International Monetary Fund, Working Paper 03/24, 2003), available at http://www.imf.org/external/pubs/ft/wp/2003/wp0324.pdf. Efficient investments optimize an investor's utility when trading off expected return and risk. If investors can more accurately estimate expected returns and risk, then they are better able to make efficient investments. For a summary of the underlying theory, see Bodie, Kane, and Marcus *Investments*, 7th ed. Chapters 8, 11, and 12.

would such data deter non-abusive short selling? For example, would such data reveal the trading strategies of non-abusive short sellers? Could the availability of such data create new opportunities for unfair or otherwise abusive market practices, such as bear raids or short squeezes? Could real time data on short positions lead to copycat trading?[27] How would real time data on short positions affect investor confidence?

Q7. How would real time data on short positions affect liquidity, volatility, price efficiency, competition, and capital formation? Would real time short position reporting affect equity-related securities markets, such as option or other derivative markets, convertible bond or other debt markets? If so, in what ways?

Q8. How should "position" be defined to help ensure any short sale position reports would be useful in detecting and deterring abusive short sale practices? Should "position" be defined differently to accomplish another purpose? If so, how, and what purpose would such a definition help accomplish? Would there be a trade-off between minimizing incremental implementation costs, above the cost of existing short reporting systems and procedures, in the context of a short position reporting regime and its utility? For maximum utility, should short positions be reported gross, or net of long positions, or in both ways? Should short positions include derivatives and index components? Should short positions be the net economic exposure to a stock across all instruments? Should short positions be defined as in former Rule 10a3-T, in which "the Form SH short position is not net of long position?"[28] In the case of broker-dealers, should position

[27] Copycat trading is a form of "herd behavior," which has been described as "[t]he tendency of investors, like herd animals, to follow the group. Such conformity can give rise to bubbles in individual securities and market sectors." Library of Congress, Federal Research Division, Annotated Bibliography on the Behavioral Characteristics of U.S. Investors (Aug. 2010), available at http://www.loc.gov/rr/frd/pdf-files/SEC_Annotated-Bibliography.pdf.

[28] See supra note 16.

reporting be based on existing Regulation SHO aggregation units within broker-dealers,[29] for the broker-dealer taken as a whole, or for its holding company? Please describe the feasibility of any incremental changes to the existing short sale reporting systems that would be necessary to report short sale "positions." Would any potential definitions of short positions be infeasible in real time?

Q9. What would be the benefits and costs of short position reporting if "position" was defined to mean short interest,[30] which would be the aggregate number of shares short in each stock? Would real time public reporting of aggregate short interest be feasible? If so, what problems would it address, and how (and by whom) would this data be used? Should the position reporting to be examined in the Division's study be more comprehensive than the current bi-monthly short interest reporting? For example, "arranged financing" (which would include borrowing from a foreign bank or affiliate to cover short positions) is not currently included in short interest. What would be the impact of including arranged financing in a definition of short position?

Q10. What would be the feasibility, benefits, and costs of real time short position reporting to regulators only, and not to the public? What would the benefits and costs be if this real time reporting information were to be made public on a delayed basis? What length of delay might best balance any benefits and costs?

Q11. Who would be in a position to report short positions in real time? Would broker-dealers be able to accurately report customer short positions in real time? Would anyone else be better suited? Would short sellers themselves be equipped to report their own short positions in real time? Would anyone but the short seller be in a position to report the

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[29] Rule 200(f) of Regulation SHO permits a broker-dealer, under certain conditions, to calculate its long or short position by independent trading-unit, rather than on a firm-wide basis. 17 CFR 242.200(f).
[30] See supra note 7.

short seller's short position, whether or not the short position was defined as the short seller's economic position including derivatives? What would be the feasibility of adapting the technology infrastructure that supports existing reporting requirements to support real time short position reporting?

Q12. Who would be in a position to collect and disseminate short positions in real time? Would it be feasible for listing exchanges to collect and disseminate this information? Would a consolidator be better suited to collect this information? What would be the feasibility of adapting the technology infrastructure supporting existing reporting requirements to support real time short position collection and dissemination? Would short position data developed from existing systems be less meaningful than data from a new system designed for this purpose? Why or why not?

Q13. What would be the direct, quantifiable costs of short position reporting for those compiling, reporting, collecting, or disseminating the data? Please differentiate implementation costs from ongoing costs and include opportunity costs. How feasible would it be for brokers, exchanges, and others to create or modify a reporting and dissemination system? What would be the particular technological challenges faced in creating or modifying a reporting and dissemination system? Responses based on the costs of implementing the 2007 modifications to short interest reporting[31] or the 2008 implementation of Form SH[32] are particularly requested.

Q14. How would the establishment of a significant reporting threshold, which would limit short position reporting requirements to holders of significant net short positions, affect

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[31] See supra note 7.

[32] This requirement was instituted via three emergency orders (dated Sep. 18, 2008, Sep. 21, 2008, and Oct. 2, 2008), which implemented Exchange Act Rule 10a-3T (See Exchange Act Release No. 58785 (Oct. 15, 2008), 73 FR 61678 (Oct. 17, 2008)). Comments are available at http://www.sec.gov/comments/s7-31-08/s73108.shtml.

costs and the utility of the short position information? If reporting thresholds would be useful, would thresholds at the 5% level used under Section 13(g) of the Exchange Act or the 0.25% level used in former Form SH[33] be appropriate, or would a lower threshold, such as that used in the U.K. model, be preferable?[34] Or would a higher threshold be appropriate? Please explain why or why not. Would thresholds (computed on a net basis) at U.K. levels (or the lower levels being contemplated by the E.U.)[35] capture ordinary course, bona fide market maker positions, or would they tend generally to capture only the positions of investors taking a view as to the stock's future price direction? Would a general exemption from position reporting (or public position reporting) for market makers be appropriate? Why or why not?

Q15. How should experiences with short sale position reporting regimes in foreign jurisdictions[36] inform the analysis of feasibility, benefits, and costs? How relevant are any analyses of other reporting regimes to the Division's study?[37] The Commission requests information on any relevant studies not cited in this request for comment.

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[33] Certain institutional investment managers were required to report short sales of certain securities on former Form SH unless the short position constituted less than 0.25% of the class of shares and had a fair market value of less than $10,000,000. See Exchange Act Release No. 58785 (Oct. 15, 2008), 73 FR 61678 (Oct. 17, 2008).

[34] Two types of short positions must be publicly disclosed in the U.K. A net short position of 0.25% and above of issued capital in a U.K. company involved in a rights issue must be disclosed. In addition, a net short position in a U.K. financial sector company must be disclosed initially when such interest exceeds 0.25% of total share capital, and on an ongoing basis when the position exceeds or falls below 0.25%, 0.35%, 0.45% and 0.55% and each 0.1% threshold thereafter. See FINMAR §§ 2.2.1, 2.1.2. See also U.K. Financial Services Authority, "Implementing Aspects of the Financial Services Act 2010" (2010), at 2.13.

[35] The E.U. Model would require reporting to regulators when short interest exceeds 0.2% of issued share capital, and reporting to the public when it exceeds 0.5% of issued share capital. See E.U. Model, at 8-9.

[36] See supra notes 17-24, 34, and 35 for examples.

[37] See Oliver Wyman Report, supra note 10, and also U.K. Financial Services Authority, Short selling: Feedback on DP09/1, 09/4 (Oct. 2009), available at http://www.fsa.gov.uk/pubs/discussion/fs09_04.pdf; European Commission, Impact Assessment on the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps , SEC(2010) 1055 (Sep. 15, 2010), available at http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_impact_assessment_en.pdf.

## III. Transaction Reporting

The Commission requests comment, on behalf of the Division, on the feasibility, benefits, and costs of the Consolidated Tape collecting and disseminating certain transaction marks. Specifically, Section 417(a)(2)(B) of the Dodd-Frank Act requires the Division to study the feasibility, benefits, and costs of conducting a voluntary pilot program in which public companies would agree to have all trades of their shares marked "long," "short," and/or "market maker short" (for the sell portion(s) of the trade), and "buy" and/or "buy to cover" (for the buy portion(s) of the trade) and reported in real time through the Consolidated Tape.

Q16. What benefits, costs, or unintended consequences would flow from adding these transaction marks to the Consolidated Tape? Who would use these marks, and how? Would data from the Consolidated Tape be accessible to the market participants who are most interested in short selling information? Would the Consolidated Tape data be too voluminous to be used directly by interested market participants? How would the Consolidated Tape marks affect the behavior of short sellers and other investors? Would Consolidated Tape marks help or hinder long-term investors in making "efficient investments?"[38] Would market commentators and others use Consolidated Tape marks to help the public better understand markets? Could such marks help to better detect, deter, or prevent identified short selling abuses? Alternatively, could such marks themselves present opportunities for alleged unfair or otherwise abusive market practices, such as bear raids or short squeezes? Would real time Consolidated Tape marks lead to copycat trading? How would Consolidated Tape marks affect investor confidence?

Q17. Please discuss the feasibility, benefits, and costs related to the "short sale," "market maker short," and "buy-to-cover" marks specifically, and the effects of any choices that

[38] See supra note 26.

would be made when defining such terms. Would there be a trade-off between defining the trades that would be subject to these marks for maximum utility and accuracy to investors, and minimizing implementation costs by building on existing definitions and order marking infrastructure?[39] If so, how should the tension between these goals be best resolved? Would there be any other potential issues associated with the accuracy or clarity of Consolidated Tape marks? Would the Consolidated Tape marks present possibilities for misinterpretation of the data that could impact any benefits and costs?

Q18. How would any additions to Consolidated Tape marks affect liquidity, volatility, price efficiency, competition, and capital formation? To what extent, if any, would such data deter short selling activity not associated with abusive market practices, but that enhances market quality, for example, by revealing trading strategies? What are the consequences of such deterrence? Would any additions to Consolidated Tape marks have consequences (including benefits or costs) for equity-related securities markets, such as options or other derivative markets, convertible bond or other debt markets? If so, please explain. What would the feasibility, benefits, and costs be if this real time reporting information were to be made public on a delayed basis? What length of delay might best balance any benefits and costs?

Q19. What would be the direct, quantifiable costs of adding the additional fields to the Consolidated Tape to support new marks? Please differentiate implementation costs from ongoing costs and include opportunity costs. How feasible would it be for brokers, exchanges, and others to modify order management systems, or other systems, for these marks? What would be the potential technological challenges faced in implementing these marks? Would the Consolidated Tape bear significant implementation or ongoing

[39] See supra note 3.

costs? For example, would capacity requirements be significantly higher? Would vendors and others who receive feeds from the Consolidated Tape bear significant implementation or ongoing costs? Responses based on the costs of implementing Regulation SHO Rule 201,[40] Regulation NMS,[41] and Form SH[42] are particularly requested.

Q20. What would be the benefits and costs (including the direct, quantifiable costs) of conducting a pilot for the Consolidated Tape marking? Would a pilot for Consolidated Tape marking be feasible? Would the direct, quantifiable costs of implementing and maintaining a pilot be any less, or more, than those of implementing and maintaining Consolidated Tape marking on all listed issuers? Would market participants be likely to behave differently during a pilot, for example by hesitating to develop new trading strategies?[43]

Q21. What would be the benefits and costs of the *voluntary* component of the pilot? What types of issuers would likely volunteer to participate in a pilot? How would this self-selection affect the usefulness of any data derived from a pilot? Are there other consequences from a *voluntary* pilot? To maximize the utility of any pilot, should the pilot be designed to limit participation in a way that facilitates comparisons of trading in pilot companies and trading in non-pilot companies? If participation should be limited,

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[40] 17 CFR 242.201.
[41] 17 CFR 242.600 et seq.
[42] See supra note 33.
[43] For example, in 2004, the Commission adopted Rule 202T, which provided for the temporary suspension of the short sale uptick rule in certain securities so that the Commission could study trading behavior in the absence of a price test. See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004). In the view of Division Staff, Boehmer, Jones, and Zhang provide evidence suggesting that trading behavior may not have completely adjusted to the Regulation SHO Pilot. See Boehmer, Jones, and Zhang, "Unshackling Short Sellers: The Repeal of the Uptick Rule" (2008), available at http://www.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3231/UptickRepealDec11.pdf.

how should the Commission determine which volunteers to include or exclude from the pilot?

Q22. How should experiences with transaction marking regimes in foreign jurisdictions[44] inform analysis of the feasibility, benefits, and costs? Are there any analyses of transaction marking regimes that are relevant to the Division's study?

Q23. To what extent would Consolidated Tape marks be a substitute or compliment to real time short position reporting? How would the benefits and costs of any Consolidated Tape marks be impacted if real time position reporting existed and vice versa?

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: May 3, 2011

[44] Several foreign jurisdictions have short sale marking requirements in place including Australia (Australian Securities and Investment Commission , Regulatory Guide, RG 196.12 (April 2010)), Canada (Universal Market Integrity Rules, Rule 3.2), Hong Kong (Hong Kong Exchange Rules, Eleventh Schedule, Rule 5), and Japan (Japan Financial Services Agency, "FSA Extends Temporary Measures Regarding Restrictions on Short Selling and Purchases of Own Stocks by Listed Companies" (Jan. 21, 2011) (effective until Apr. 30, 2011)).

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64388 / May 4, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14367**

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| **In the Matter of**<br><br>**Dijji Corp.,**<br>**Hydro Environmental Resources, Inc. (n/k/a EXIM Internet Group, Inc.),**<br>**Hydrogen Power, Inc., and**<br>**InsynQ, Inc.**<br><br>**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 Dijji Corp., Hydro Environmental Resources, Inc. (n/k/a EXIM Internet Group, Inc.), Hydrogen Power, Inc., and InsynQ, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Dijji Corp. ("DJJI") [1] (CIK No. 1158134) is a revoked Nevada corporation located in Seattle, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DJJI 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, 2005, which reported a net loss of $2,521,000 for the prior year. On June 19, 2006, DJJI filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Nevada, which was still pending as of April 26, 2011. As of April 26, 2011, the common stock of DJJI

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

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

2. Hydro Environmental Resources, Inc. (n/k/a EXIM Internet Group, Inc.) ("EXGN") (CIK No. 1081260) is a revoked Nevada corporation located in Mercer Island, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). EXGN is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2004, which reported a net loss of $160,759 for the prior nine months. As of April 26, 2011, the common stock of EXGN was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Hydrogen Power, Inc. ("HYDP") (CIK No. 716101) is a void Delaware corporation located in Seattle, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). HYDP 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, 2007, which reported a net loss of $19,508,446 for the prior nine months. As of April 26, 2011, the common stock of HYDP 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. InsynQ, Inc. ("INSQ") (CIK No. 914626) is a Nevada corporation located in Tacoma, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). INSQ 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 November 30, 2005, which reported a net loss of $1,337,142 for the prior six months. As of April 26, 2011, the common stock of INSQ was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

5. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, 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**

**May 4, 2011**

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| **In the Matter of**<br><br>**Dijji Corp.,**<br>**Hydro Environmental Resources, Inc. (n/k/a EXIM Internet Group, Inc.),**<br>**Hydrogen Power, Inc., and**<br>**InsynQ, Inc.,**<br><br>**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 Dijji Corp. because it has not filed any periodic reports since the period ended December 31, 2005.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Hydro Environmental Resources, Inc. (n/k/a EXIM Internet Group, Inc.) because it has not filed any periodic reports since the period ended September 30, 2004.

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of InsynQ, Inc. because it has not filed any periodic reports since the period ended November 30, 2005.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on May 4, 2011 and terminating at 11:59 p.m. EDT on May 17, 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**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64396 / May 4, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14368**

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| **In the Matter of**<br><br>**PAUL N. NICHOLSON,**<br><br>**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 Paul N. Nicholson ("Respondent" or "Nicholson").

**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. Nicholson, age 56, resides in Corona Del Mar, California. From 1990 to 2010, he served as the president and member owner of Macarthur Strategies, Inc. ("Macarthur"), a registered broker-dealer with a principal place of business in Irvine, California. From 1996 to 2010, he also was the owner and president of Professional Investment Exchange, Inc. ("PIE"), which is the general partner for various issuers of limited partnership interests. Nicholson has series 7, 24, 39 and 63 securities licenses.

2. On April 12, 2011, an agreed judgment was entered by consent against Nicholson, permanently enjoining him from future violations of Sections 5 and 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Paul N. Nicholson, et al., Civil Action Number 8:11-CV-00546-JVS-RNB, in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that, in connection with the sale of limited partnership interests, Nicholson misused and misappropriated investor funds, including, among other things, using investor funds to pay undisclosed commissions to unlicensed salespeople, to pay Macarthur's expenses and to pay undisclosed personal salary and expenses. The complaint also alleged that in communications with potential and existing investors, Nicholson engaged in conduct that operated as a fraud and deceit on investors, including by omitting material information about the use of investor proceeds and about the past performance of Nicholson's and PIE's oil-and-gas ventures. The complaint further alleged that Nicholson sold unregistered securities and that he operated PIE as an unregistered broker-dealer.

## IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Nicholson 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, or from participating in an offering of 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

Commissioner Walter
Commissioner Aguilar
not participating.

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64398 / May 4, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3193 / May 4, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14369**

**In the Matter of**

**MARK ZAINO,**

**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 Mark Zaino ("Zaino" or "Respondent").

**II.**

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

## III.

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

1. From approximately March 2001 until December 2006, Zaino was employed by UBS Financial Services Inc. ("UBS"), a broker-dealer and an investment adviser registered with the Commission. During the relevant time period, Zaino worked on UBS's Municipal Reinvestment and External Derivatives Desk in New York City, first as a Senior Analyst, then as an Associate Vice President and an Assistant Vice President, and finally as a Director. Zaino marketed municipal reinvestment products such as forward purchase and repurchase agreements. Zaino also acted as a bidding agent for municipal investment products on behalf of various issuers of municipal securities. Zaino held Series 7 (General Securities Representative) and Series 63 (Uniform Securities Agent) securities licenses. Zaino, age 36, is a resident of Connecticut.

2. On May 17, 2010, in United States v. Mark Zaino, Criminal No. 10-CR-00434-TPG, Zaino pled guilty to two counts of conspiracy in violation of 15 U.S.C. § 1 and 18 U.S.C. § 371, respectively, and to one count of wire fraud in violation of 18 U.S.C. § 1343 before the United States District Court for the Southern District of New York. Zaino is currently scheduled to be sentenced in December 2011.

3. The criminal information to which Zaino pled guilty charged, among other things, that Zaino engaged in fraudulent misconduct in connection with the competitive bidding process for the selection of the firms to provide instruments in which municipal issuers, in accordance with federal tax laws and regulations, temporarily invested the proceeds of tax-exempt municipal bonds. More specifically, the information charged that, from at least as early as October 2001 until March 2006, Zaino conspired to allocate and rig bids for investment agreements or other municipal finance contracts, in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1. The information further charged that, from at least as early as August 2001 until at least March 2006, Zaino, in violation of 18 U.S.C. § 371, conspired to defraud the United States and an agency thereof, the Internal Revenue Service of the United States Department of Treasury ("IRS"), by impeding, impairing, obstructing, and defeating the lawful government functions of the IRS in the ascertainment, computation, assessment, and collection of revenue due and owing from municipal issuers and in the exercise of its responsibilities to monitor compliance with Treasury regulations related to tax-exempt municipal securities. In addition, the information charged that Zaino having devised a scheme and artifice to defraud municipal issuers and obtain money and property from municipal issuers by means of false and fraudulent pretenses, representations and promises, namely a scheme to deprive municipalities of money by facilitating the payment of kickbacks through the execution of swap transactions and by submitting intentionally losing bids, and that he, for purposes of executing such scheme and attempting to do so, transmitted and caused to be transmitted by means of wire, radio, or television communication in interstate commerce, writings, signs, signals, pictures or sounds, in violation of 18 U.S.C. § 1343.

## IV.

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64391 / May 4, 2011

Admin. Proc. File No. 3-14206

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| In the Matter of the Application of<br><br>DENISE LYNN GIZANKIS<br><br>For Review of Action Taken by<br><br>FINRA | ORDER DISMISSING PETITION FOR REVIEW |

On January 25, 2011, Denise Lynn Gizankis, formerly a registered representative associated with Wells Fargo Advisors, LLC ("Wells Fargo"), a FINRA member firm, filed an application for review of FINRA disciplinary action. FINRA barred Gizankis pursuant to FINRA Rule 9552[1] for failing to respond to a request to provide information pursuant to Rule 8210[2] in connection with her termination from Wells Fargo. In her application for review, Gizankis requested that the Commission set aside the bar. Gizankis explained that, because she recently relocated to another state, she had not received FINRA's information requests or the subsequent suspension notices that resulted in her bar.

On March 16, 2011, FINRA filed with the Commission a "Motion to Dismiss Application for Review and to Stay Briefing Schedule." In its motion, FINRA states that Gizankis's application for review included "information responsive to FINRA's information requests." FINRA explains that, as a result of "Gizankis's willingness to respond to FINRA's request for information and the extraordinary circumstances that made her unavailable," Gizankis and FINRA entered into a Letter of Acceptance, Waiver, and Consent, in which Gizankis agreed to settle the matter "for a sanction less than a bar." FINRA accordingly asserts that Gizankis's

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[1] FINRA Rule 9552 provides that FINRA may suspend a person subject to FINRA's jurisdiction who fails to provide information and that, if the person subsequently fails to request termination of the suspension within three months, that person will be automatically barred.

[2] FINRA Rule 8210 requires persons associated (or formerly associated) with a member firm to provide information with respect to any matter related to an investigation, complaint, or proceeding.

application for review is now moot and requests that the Commission dismiss Gizankis's application for review. Gizankis, by signing the motion, assents to FINRA's request. Under the circumstances, we find it appropriate to grant FINRA's motion to dismiss Gizankis's application for review.[3]

Accordingly, it is ORDERED that Denise Lynn Gizankis's application for review be, and it hereby is, dismissed.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

[3] Because briefing has not yet been scheduled, FINRA's additional request that the Commission stay briefing is unnecessary.

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

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3194 / May 5, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14371**

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| **In the Matter of**<br><br>**DOUGLAS K. LANDEEN,**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINDS, AND IMPOSING REMEDIAL SANCTIONS** |

**I.**

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

**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 purposes of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.5 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1930, 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. Landeen is a resident of Bristol, Connecticut, and between at least September 22, 2008 and May 5, 2010, sought to become associated with entities that were registered or seeking registration as investment advisers in the state of Connecticut.

2. On September 22, 2008, Landeen filed with the Securities and Business Investments Division (the "Division") of the Connecticut Department of Banking (the "Department"), a Form U-4 (Uniform Application for Securities Industry Registration or Transfer) to register as an agent of an investment adviser registered with the state of Connecticut. Landeen's registration became effective on September 22, 2008 and was terminated on April 17, 2009.

3. On October 27, 2009, Landeen filed with the Division a Form U-4 to register as an agent of an entity that was seeking registration as an investment adviser with the state of Connecticut.

4. In both his September 2008 and October 2009 Form U-4s filed with the state of Connecticut, Landeen responded "no" to a question asking whether he had been previously convicted of a felony. Those responses were false because on July 29, 1998, Landeen was convicted of Mail Fraud (18 U.S.C. § 1341), and Willful Subscription to a False Tax Return (26 U.S.C. §7206A), both felonies. *See United States v. Landeen*, No. 3:98-CR-00063 (D. Conn., Jul. 29, 1998).

5. On May 5, 2010, the Banking Commissioner for the Department entered a Consent Order (the "Order") in an administrative action entitled In Re: Douglas Kirk Landeen, Docket No. NDCD-2010-7769-S. The Order stated that Respondent violated provisions of Connecticut's Uniform Securities Act and Sections 36b-23 and 36b-31-14e of the Regulations of Connecticut State Agencies, promulgated thereunder, which prohibit providing or failing to amend false or incomplete information in documents filed with the Banking Commissioner. The Order barred Landeen for ten years from transacting business in or from Connecticut as a broker-dealer, agent, investment adviser, or investment adviser agent, as such terms are defined by the Connecticut Uniform Securities Act.

**IV.**

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

Accordingly, it is hereby ORDERED:

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64412 / May 5, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3195 / May 5, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14372

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| In the Matter of<br><br>BRETT S. KLEESE,<br><br>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 Brett S. Kleese ("Kleese" or "Respondent").

II.

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

## III.

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

1. Kleese, age 46, is a resident of Mesa, Arizona. From April 12, 2002 until May 22, 2008, Kleese was a registered representative associated with World Group Securities, Inc., ("World Group Securities") a broker-dealer registered with the Commission. From August 16, 2006 until May 22, 2008, Kleese was also associated with Investment Advisors International, Inc., an investment adviser registered with the Commission.

2. In February 2009, the Arizona Corporation Commission, which serves as Arizona's securities commission, entered a final order In the Matter of Brett S. Kleese et al, Decision No. 70752 (Arizona Corporation Commission, Feb. 24, 2009) ("Arizona Order"), by consent, against Kleese which found that he violated the anti-fraud and registration provisions of Arizona's securities laws. The Arizona Order required Kleese to cease and desist from violating the state's securities laws, pay restitution of $2.4 million for return to investors, pay $100,000 in penalties, and revoked his state securities salesman registration and investment adviser representative license.

3. The Arizona Order to which Kleese consented alleged that Kleese violated Arizona's anti-fraud and securities registration statutes in connection with the offer and sale of promissory notes issued by his company, BSK Enterprises, LLC ("BSK"). As part of the order, Kleese admitted to the following facts. From on or about October 2007 to May 2008, Kleese offered and sold $2,980,000 of unregistered securities in the form of promissory notes issued by BSK to 57 investors. The promissory notes contained promises by BSK to repay the investors' principal investments plus interest by the expiration date of the promissory note. Kleese told investors that BSK would lend their funds to Rosand Enterprises, Inc. ("Rosand"), and Rosand would use the funds as collateral in obtaining a line of credit to pay for the construction of pre-fabricated, low-cost housing in Chicago. Kleese represented that the investor funds sent to Rosand would be deposited into an Illinois law firm's trust account, that none of the money would be withdrawn from the account because it was to be used by Rosand only as collateral for the line of credit, and that the account was covered by a bond. Contrary to what Kleese represented to investors, the funds sent to Rosand were withdrawn from the law firm's trust account and were not covered by a bond. Kleese admitted that he did not adequately disclose these facts to investors.

## IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, PL 111-203, July 21, 2010, 124 Stat. 1376, and Section 203(f) of the Advisers Act, Respondent Kleese be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

Respondent be, and herby 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.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3196 / May 5, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14373**

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| **In the Matter of**<br><br>**GUY ALBERT de CHIMAY,**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Guy Albert de Chimay ("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.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

## III.

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

1. Respondent in 1987 founded Chimay Capital Management, Inc. ("Chimay Capital"), a New York-based, unregistered investment adviser, and served as its chairman and chief investment officer at all times relevant to this matter. Chimay Capital claimed to be the U.S. investment arm of the Chimay family, a line of wealthy Belgian royalty dating to the fourteenth century. Respondent, who claimed to be related to royalty, purported to manage $200 million on behalf of the royal family and outside investors. Respondent, 47, is a resident of New York, New York.

2. The Commission's amended complaint, dated July 14, 2010, alleged that, in connection with an investment vehicle known as the "Bridge Loan Facility," Respondent misused and misappropriated investor funds, and falsely stated to investors that their funds would be invested and would earn returns of twelve percent. The amended complaint alleged that at least $6 million of investor money was diverted for Respondent's personal use, including to subsidize his lifestyle, to pay off disgruntled counterparties to unrelated transactions, and to pay early investors in the Bridge Loan Facility who demanded return of their investment. No investment in the Bridge Loan Facility actually was made. In order to facilitate and then conceal the fraud, Respondent falsified bank statements to reflect that he had millions of dollars at his disposal, most of it purportedly in offshore bank accounts.

3. On January 31, 2011, a partial judgment was entered by consent against Respondent, permanently enjoining him from future violations of Section 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. Chimay Capital Management, Inc. and Guy Albert de Chimay, Civil Action Number 1:10-cv-04582 (WHP), in the United States District Court for the Southern District of New York. The partial judgment deferred ruling on disgorgement, prejudgment interest and civil penalties pending future motion by the Commission.

## IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent be, and hereby is barred from association with any broker, dealer, investment adviser, transfer agent, municipal securities dealer, municipal advisor, and 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.

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. 64442 / May 9, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3197 / May 9, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14374

In the Matter of

ALETHEIA RESEARCH AND MANAGEMENT, INC., PETER J. EICHLER, JR. and ROGER B. PEIKIN

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER AS TO ALETHEIA RESEARCH AND MANAGEMENT, INC., PETER J. EICHLER, JR. AND ROGER B. PEIKIN

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 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Aletheia Research and Management, Inc. ("Aletheia") and Sections 203(f) and 203(k) of the Advisers Act against Peter J. Eichler, Jr. ("Eichler") and Roger B. Peikin ("Peikin") (Aletheia, Peikin and Eichler referred to as collectively as "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 Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and A Cease-and-Desist Order ("Order"), as set forth below.

## III.

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

## SUMMARY

These proceedings concern violations of the Investment Advisers Act by a registered investment adviser, Aletheia, and its two principals, Eichler and Peikin:

- From 2006 to 2008, Aletheia disseminated proposals to client and potential clients that failed to disclose requested information regarding prior Commission examinations, which Peikin reviewed.
- Aletheia and Peikin failed to implement written procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder regarding responding to requests for proposals from prospective clients.
- For fiscal years 2003 through 2008, Aletheia, Eichler, and Peikin failed to have an annual surprise examination of Aletheia's hedge funds and to provide the hedge fund investors with quarterly account statements, or provide the hedge fund investors with timely annual audit reports.
- From 2005 through 2009, Aletheia, Eichler, and Peikin failed to make and/or keep copies of the employees' acknowledgments indicating the receipt of Aletheia's code of ethics even after receiving 2005 and 2008 deficiency letters notifying Aletheia of that requirement.

## RESPONDENTS

1. Aletheia Research and Management, Inc. ("Aletheia") is a California corporation with its principal place of business in Santa Monica, California. Aletheia (File No. 801-55761) is registered with the Commission as an investment adviser and its wholly-owned subsidiary Aletheia Securities, Inc. ("ASI") is a registered broker-dealer. As of December 31, 2009, it had over $7.1 billion in assets under management.

2. Peter J. Eichler, Jr. ("Eichler") resides in Pacific Palisades, California. Eichler is Aletheia's co-founder, chairman, CEO, president, Chief Investment Officer ("CIO"), director, and largest shareholder. Eichler is also an officer, director and control person of ASI. He received a B.S. degree from Santa Clara University. Before forming Aletheia, he worked at a number of large brokerage firms. Eichler holds series 7, 24, 63 and 65 securities licenses.

3. Roger B. Peikin ("Peikin") resides in Santa Monica, California. Peikin is Aletheia's co-founder, director, and second largest shareholder. Until February 2010, he was also Aletheia's CCO, and until July 2010, he was its CFO, executive vice president and general counsel. Until July 2010, Peikin was also an officer and control person of ASI. He received his JD from Southwestern University School of Law in 1991 and has been admitted to practice law in California since 1991. Peikin holds a series 27 securities licenses.

## FACTS

### Background

4. As of December 31, 2009, Aletheia managed over $7.1 billion in assets for more than 5,400 clients consisting of retail accounts, institutional clients, and two private hedge funds. During the relevant period, Eichler was the CEO and CIO of Aletheia and managed all aspects of Aletheia and was solely responsible for all investment decisions. Peikin was an executive vice president, general counsel, CCO and CFO of Aletheia and was primarily responsible for directing Aletheia's backroom operations. Peikin reported to Eichler.

### Aletheia's Response To Requests For Proposals

5. As part of their due diligence process for selecting or retaining investment advisers, clients and prospective clients sent Aletheia questionnaires called Request for Proposals ("RFPs") that requested certain information about Aletheia, including information about its background and investment performance. In 10 RFPs between 2005 and 2008, clients and prospective clients asked whether Aletheia had had any "findings," "deficiencies," or "corrective actions required" in connection with the SEC's prior examination. Some of the RFPs also requested a copy of the SEC's deficiency letter and Aletheia's reply. In response, Aletheia either: (1) stated that "there were no significant findings" in its most recent SEC examination; (2) did not answer the question; (3) referred to its broker-dealer (ASI) when answering the question in the negative and/or (4) provided a copy of the deficiency letter and reply for ASI (rather than for Aletheia).

6. Aletheia's responses were incorrect. In fact, as part of the 2005 examination, the staff sent Aletheia a seven page letter dated May 13, 2005, reporting six deficiencies found during the exam.

7. Peikin knew or should have known of the 2005 Aletheia exam and deficiencies. He received the deficiency letter and signed Aletheia's reply letter. Peikin participated in the RFP process by reviewing Aletheia's responses to the RFPs. Peikin should have, at a minimum, verified the SEC's deficiency letter in response to the RFPs.

8. As a result of the conduct described above, Aletheia willfully committed violations[1] of, and Peikin willfully aided and abetted and caused violations of, Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client.

**Failure to Implement Existing Procedures in Aletheia's Compliance Manual Relating to Responses to the RFPs**

9. Between 2005 and 2008, Aletheia made a concerted effort to attract institutional clients in order to increase the assets that it managed by soliciting prospective clients through its responses to the RFPs. As a direct result, Aletheia's assets under management (and associated management fees) increased from $225 million in 2005 to over $9 billion in 2008. Aletheia had a compliance manual that required Peikin, its CCO, to review the response to the RFPs for any misleading statement. However, Peikin failed to adequately review the RFP responses by correcting the misleading statements about the prior SEC examination.

10. As a result of the conduct described above, Aletheia willfully committed violations of, and Peikin willfully aided and abetted and caused violations of, Section 206(4) of the Advisers Act, and Rule 206(4)-7 promulgated thereunder, which requires that an investment adviser registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and rules adopted under the Adviser Act.

**Late Hedge Fund Examinations**

11. Aletheia is the general partner and adviser for two private hedge funds, the Aletheia Insider Index, LP ("Index I") and the Aletheia Insider Index II, LP ("Index II"), which had total assets of $75 million as of December 31, 2009. As a registered investment adviser, Aletheia was required by the Advisers Act and rules thereunder to send quarterly account statements to the limited partners and to ensure that its independent accountant conducted an unannounced (i.e., surprise ) annual examination to verify the partnerships' funds and securities. Under an exception and in lieu of these requirements, Aletheia was permitted to complete and distribute to each limited partner an annual audited financial statement within 120 days of the end of the fund's fiscal year, which was December 31.

12. In response to these Advisers Act requirements, Aletheia opted to distribute annual audits to the funds' investors. However, from 2003 through 2008, Aletheia failed to comply with

[1] 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)).

the Advisers Act provisions because it distributed the funds' audited financial statements to the investors from 1½ to 14 months after they were due.[2]

13. Aletheia's late distribution of the funds' audited financial statements resulted from many factors, including Aletheia's failure to timely pay the auditors, not having the funds' books and records properly organized for its auditors, problems with its portfolio management software, and Eichler's and Peikin's desire to complete other Aletheia audits or reviews first.

14. Eichler and Peikin were aware of the delays related to each audit. In fact, in some instances they directly caused the delays. For example, Eichler and Peikin jointly were responsible for signing the checks to pay the audit bills that were past due. However, in at least one instance, Eichler and Peikin simply did not jointly sign the check to pay the auditor.

15. As a result of the conduct described above, Aletheia willfully committed violations of, and Eichler and Peikin willfully aided and abetted and caused violations of, Section 206(4) of the Advisers Act, and Rule 206(4)-2(a) promulgated thereunder, which requires that an investment adviser registered with the Commission maintain each client's funds in bank accounts containing only those client funds, notify its clients about the place and manner in which their funds are maintained, reasonable believe that each client has received at least a quarterly account statement and have client funds and securities verified by an independent public accountant at least once a year without prior notice to the investment adviser.

**Books and Records – Failure to Make and Keep Acknowledgments**

16. As required by the Advisers Act rules, Aletheia had a code of ethics, which was included in its compliance manual, which required Aletheia to provide the code to all employees and to have each employee sign an acknowledgment that he or she had received the code. The Advisers Act rules also required Aletheia to maintain the signed acknowledgment pages for five years. However, from 2005 through 2007, Aletheia did not make and/or maintain any of the required acknowledgment pages and, for 2008 and 2009, Aletheia only made and/or maintained the required acknowledgment pages for just two employees. Between 2005 and 2009, Aletheia had between 14 and 28 employees.

17. As Aletheia's CCO, Peikin was responsible for receiving and maintaining the acknowledgment pages. Moreover, Aletheia, Peikin and Eichler were advised in the 2005 deficiency letter that not a single Aletheia employee had completed an acknowledgment of receipt. Yet, even though there was sufficient time in 2005 to have the acknowledgment pages signed and retained, they did not. In 2008, Aletheia was once again made aware of the need to make and maintain copies of the acknowledgment pages by the 2008 deficiency letter. Yet, even after receiving a second deficiency letter in four years, Aletheia, Eichler and Peikin failed to make and/or maintain all of the acknowledgment pages for 2008 and 2009.

[2] Index I's first audit was for 2003; Index II first audit was for 2006.

18. As a result of the conduct described above, Aletheia willfully committed violations of, and Eichler and Peikin willfully aided and abetted and caused violations of, Section 204(a) of the Advisers Act, and Rule 204-2(a)(12) promulgated thereunder, which require that investment advisers registered with the Commission maintain a record of all written acknowledgments as required by Rule 204A-1(a)(5) for each person who is currently, or within the past five years was, a supervised person of the investment adviser.

## REMEDIAL EFFORTS

19. In determining to accept the Offers, the Commission considered remedial acts undertaken by Respondents and cooperation afforded the Commission staff. Specifically, during the Commission's staff investigation, Aletheia hired an independent consultant (the "Independent Consultant") to evaluate its compliance practices and procedures, and Aletheia is implementing its recommendations.

## UNDERTAKINGS

20. Within thirty (30) days of the issuance of this Order, Respondent Aletheia undertakes to mail a copy of the Form ADV which incorporates the paragraphs contained in Section III of this Order to each of Aletheia's existing clients, and specify that the entire Order will be posted on the homepage of Aletheia's website. Within thirty (30) days of the issuance of this Order, Respondent Aletheia also undertakes to post a copy of this Order on the homepage of Aletheia's website and maintain this copy of the Order on Aletheia's website for a period of six (6) months. Respondent Aletheia shall also provide a copy of the Form ADV to any new client that engages Aletheia or Eichler within one (1) year of the date of this Order.

21. Respondent Aletheia shall comply with the following undertakings:

a. To continue to retain the Independent Consultant, at its expense. Aletheia shall require the Independent Consultant to conduct any additional review of Aletheia's compliance policies and procedures that the Independent Consultant deems appropriate with respect to Sections 204(a), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(12), 206(4)-2(a) and 206(4)-(7) thereunder including:

(1) complying with the record retention requirements relating to written acknowledgements;

(2) ensuring that the responses to the RFPs do not contain any material misrepresentations or omissions;

(3) providing quarterly account statements to the limited partners; and hire an independent public accountant to conduct a surprise

examination of the adviser's records annually to verify all the clients' funds and securities, or in lieu of these requirements, complying with any statutory exceptions;

(4) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, including implementing procedures related to the responses to RFPs; and

(5) complying with such other policies or procedures as are reasonably expected to prevent and detect the types of violations of the federal securities laws involving Aletheia's actions described in Section III;

b. At the end of that review, which in no event shall be more than three (3) months after the date of the issuance of this Order, Aletheia shall require the Independent Consultant to submit to Aletheia and to the Commission's Los Angeles Regional Office an Initial Report. The Initial Report shall describe the review performed, the conclusions reached and shall include any recommendations deemed necessary to make the policies and procedures adequate. Aletheia may suggest an alternative procedure designed to achieve the same objective or purpose as that of the recommendation of the Independent Consultant. The Independent Consultant shall evaluate Aletheia's proposed alternative procedure. Aletheia, however, shall abide by the Independent Consultant's final recommendation;

c. Within six (6) months of the date of this Order, Aletheia shall, in writing, advise the Independent Consultant and the Commission's Los Angeles Regional Office of the recommendations it is adopting;

d. Within nine (9) months of the date of this Order, Aletheia shall require the Independent Consultant to complete its review and submit a written final report to Aletheia and the Commission's Los Angeles Regional Office. The Final Report shall describe the review made of Aletheia's compliance policies and procedures relating to Sections 204(a), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(12), 206(4)-2(a) and 206(4)-(7) thereunder; set forth conclusions and recommendations and any proposals by Aletheia; and describe how Aletheia is implementing those recommendations and proposals;

e. Aletheia shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Independent Consultant's Final Report;

f. No later than three (3) months after the date of the Independent Consultant's final report, Aletheia shall submit to the Commission's Los

Angeles Regional Office an affidavit setting forth the details of its efforts to implement the Independent Consultant's recommendations as set forth in the Final Report and its compliance with them;

g. For good cause shown and upon timely application by the Independent Consultant or Aletheia, the Commission's staff may extend any of the deadlines set forth in these undertakings; and

h. Aletheia shall require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Aletheia, 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 Aletheia, 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.

22. Aletheia shall certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission's staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to John McCoy, Associate Director, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., Ste. 1100, Los Angeles, CA 90036, 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.

## 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) of the Exchange Act and Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Aletheia cease and desist from committing or causing any violations and any future violations of Sections 204(a), 206(2), and 206(4) of the Advisers Act and Rules 204-2(a)(12), 206(4)-2(a), and 206(4)-7 promulgated thereunder;

B. Respondent Eichler cease and desist from committing or causing any violations and any future violations of Sections 204(a) and 206(4) of the Advisers Act and Rules 204-2(a)(12) and 206(4)-2(a) promulgated thereunder;

C. Respondent Peikin cease and desist from committing or causing any violations and any future violations of Sections 204(a), 206(2), and 206(4) of the Advisers Act and Rules 204-2(a)(12), 206(4)-2(a), and 206(4)-7 promulgated thereunder;

D. Respondents Aletheia, Eichler and Peikin are censured.

E. Respondent Aletheia shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $200,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission,100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Aletheia as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John McCoy, Associate Director, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., Ste. 1100, Los Angeles, CA 90036.

F. Respondent Eichler shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Eichler as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John McCoy, Associate Director, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., Ste. 1100, Los Angeles, CA 90036.

G. Respondent Peikin shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission,100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Peikin as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John

McCoy, Associate Director, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., Ste. 1100, Los Angeles, CA 90036.

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. 64443 / May 9, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14375**

| | |
|---|---|
| **In the Matter of**<br><br>**Davin Computer Corp.,**<br>**Debbie Reynolds Hotel & Casino, Inc.,**<br>**Dentlcare Management, Inc.,**<br>**Desert West Marketing, Inc.,**<br>**Designer & Decorator House, Inc. (n/k/a Designer & Decorator House, LLC),**<br>**Diamond Hitts Production, Inc.,**<br>**Digital Music Creations, Inc., and**<br>**DotCom Visions, Inc.,**<br><br>**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 Davin Computer Corp., Debbie Reynolds Hotel & Casino, Inc., Dentlcare Management, Inc., Desert West Marketing, Inc., Designer & Decorator House, Inc. (n/k/a Designer & Decorator House, LLC), Diamond Hitts Production, Inc., Digital Music Creations, Inc., and DotCom Visions, Inc.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Davin Computer Corp. (CIK No. 795803) is a void Delaware corporation located in Longmont, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Davin Computer 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, 1994, which reported a net loss of over $20,000 for the prior three months.

2. Debbie Reynolds Hotel & Casino, Inc. (CIK No. 1006499) is a revoked Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Debbie Reynolds Hotel & Casino 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, 1997, which reported a net loss of over $3 million for the prior nine months. On July 3, 1997, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Nevada, and the case was terminated on August 25, 2003.

3. Dentlcare Management, Inc. (CIK No. 1006728) is a revoked Nevada corporation located in Hoffman Estates, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Dentlcare Management 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, 1997, which reported a net loss of over $1.8 million for the prior nine months. On February 24, 1999, Dentlcare Management filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Illinois, and the case was terminated on April 5, 2000.

4. Desert West Marketing, Inc. (CIK No. 1083403) is a defaulted Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Desert West 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 December 31, 2000, which reported a net loss of over $1,500 for the prior nine months.

5. Designer & Decorator House, Inc. (n/k/a Designer & Decorator House, LLC) (CIK No. 64605) is a dissolved Nevada limited liability company located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Designer & Decorator House 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 November 30, 2000, which reported a net loss of over $53,000 for the prior three months.

6. Diamond Hitts Production, Inc. (CIK No. 949857) is a Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Diamond Hitts Production is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2002, which reported a net loss of over $300,000 for the prior nine months.

7. Digital Music Creations, Inc. (CIK No. 1075975) is a dissolved Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Digital Music Creations is delinquent in its periodic filings with the Commission, having not filed any periodic

reports since it filed a Form 10-QSB for the period ended March 31, 2000, which reported a net loss of over $16,000 since its inception on September 29, 1998.

8. DotCom Visions, Inc. (CIK No. 1121879) is a void Delaware corporation located in Mesa, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DotCom Visions is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended April 30, 2001, which reported a net loss of over $8,600 for the prior twelve 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.

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
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter,
Commissioner Aguilar
not participating

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC - 29666; 812-13902]

UBS AG., et al.; Notice of Application and Temporary Order

May 9, 2011

Agency: Securities and Exchange Commission ("Commission").

Action: Temporary order and notice of application for a permanent order under section 9(c) of the Investment Company Act of 1940 ("Act").

Summary of Application: Applicants have received a temporary order exempting them from section 9(a) of the Act, with respect to an injunction entered against UBS Financial Services Inc. ("UBSFS") on May 6, 2011 by the United States District Court for the District of New Jersey ("Injunction") until the Commission takes final action on an application for a permanent order. Applicants also have applied for a permanent order.

Applicants: UBSFS; UBS AG; UBS IB Co-Investment 2001 GP Limited ("ESC GP"); UBS Alternative and Quantitative Investment LLC ("UBS Alternative"); UBS Willow Management, L.L.C. ("UBS Willow"), UBS Eucalyptus Management, L.L.C. ("UBS Eucalyptus") and UBS Juniper Management, L.L.C. ("UBS Juniper") (UBS Willow, UBS Eucalyptus, and UBS Juniper are referred to collectively as "UBS Alternative Managers"); UBS Global Asset Management (Americas) Inc. ("UBS Global AM Americas"); and UBS Global Asset Management (US) Inc. ("UBS Global AM US") (each an "Applicant" and collectively, the "Applicants").[1]

Filing Dates: The application was filed on May 9, 2011.

Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving applicants with a copy of the request, personally or by mail.

[1] Applicants request that any relief granted pursuant to the application also apply to any other company of which USBFS is or may become an affiliated person (together with the applicants, the "Covered Persons").

Hearing requests should be received by the Commission by 5:30 p.m. on June 3, 2011, and should be accompanied by proof of service on applicants, in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; Applicants: UBSFS, 1200 Harbor Boulevard, Weehawken, NJ 07086; UBS AG and ESC-GP, c/o UBS Investment Bank, 677 Washington Boulevard, Stamford, CT 06901; UBS Alternative, 677 Washington Boulevard, Stamford, CT 06901;UBS Willow, UBS Eucalyptus, and UBS Juniper, 299 Park Avenue, 29th Floor, New York, NY 10171; UBS Global AM Americas, One North Wacker Drive, Chicago, IL 60606 and UBS Global AM US, 1285 Avenue of the Americas, 12th Floor, New York, NY 10019.

For Further Information Contact: Jean E. Minarick, Senior Counsel, at 202-551-6811 or Daniele Marchesani, Branch Chief, at 202-551-6821 (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a temporary order and summary of the application. The complete application may be obtained via the Commission's website by searching for the file number, or an applicant using the Company name box, at http://www.sec.gov/search/search.htm, or by calling (202) 551-8090.

Applicants' Representations:

1. UBS AG, a company organized under the laws of Switzerland, is a Swiss-based global financial services firm. UBS AG and its subsidiaries provide global wealth management, securities and retail and commercial banking services. Each of the Applicants is either directly or indirectly controlled by UBS AG. UBSFS is a corporation organized under the laws of Delaware and provides a wide range of wealth management services, including financial

planning and wealth management consulting, asset-based and advisory services and transaction-based services, to clients in the United States and throughout the world. UBSFS, UBS Alternative, UBS Alternative Managers,[2] and UBS Global AM Americas are investment advisers registered under the Investment Advisers Act of 1940, and all but UBSFS currently serve as investment advisers to registered management investment companies ("Funds"). UBSFS and UBS Global AM US are registered as broker-dealers under the Securities and Exchange Act of 1934 ("Exchange Act"). UBS Global AM US serves as principal underwriter to various open-end Funds. UBS AG and ESC GP provide investment advisory services to employees' securities companies ("ESCs"), as defined in section 2(a)(13) of the Act, which provide investment opportunities for highly compensated key employees, officer, directors and current consultants of UBS AG and its affiliates.

2. On May 6, 2011, the United States District Court for the District of New Jersey entered a judgment, which included the Injunction, against UBSFS ("Judgment") in a matter brought by the Commission.[3] The Commission alleged in the complaint ("Complaint") that UBSFS violated section 15(c) of the Exchange Act on account of the conduct of certain former employees of UBSFS with respect to the temporary investment of proceeds of tax-exempt municipal securities in reinvestment products such as guaranteed investment contracts, repurchase agreements, and forward purchase agreements. Beginning in 2000 and continuing through 2004, the former employees are alleged to have participated in conduct in connection with the competitive bidding for these products that involved the steering of business to UBSFS and the submission of purposefully non-winning bids in UBSFS's capacity as a reinvestment provider, and the steering of business to other firms in the UBSFS's capacity as a bidding agent.

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[2] UBS Alternative is managing member of UBS Alternative Managers.

[3] Securities and Exchange Commission v. UBS Financial Services Inc., Case No. 11-cv-2539-WJM (D. N.J. May 6, 2011).

Without admitting or denying any of the allegations in the Complaint, UBSFS consented to the entry of the Injunction and other equitable relief, including certain undertakings.

Applicants' Legal Analysis:

1. Section 9(a)(2) of the Act, in relevant part, prohibits a person who has been enjoined from engaging in or continuing any conduct or practice in connection with the purchase or sale of a security, or in connection with activities as an underwriter, broker or dealer, from acting, among other things, as an investment adviser or depositor of any registered investment company or a principal underwriter for any registered open-end investment company, registered unit investment trust, or registered face-amount certificate company. Section 9(a)(3) of the Act makes the prohibition in section 9(a)(2) applicable to a company, any affiliated person of which has been disqualified under the provisions of section 9(a)(2). Section 2(a)(3) of the Act defines "affiliated person" to include, among others, any person directly or indirectly controlling, controlled by, or under common control, with the other person. Applicants state that UBSFS is an affiliated person of each of the other Applicants within the meaning of section 2(a)(3). Applicants state that, as a result of the Injunction, they would be subject to the prohibitions of section 9(a).

2. Section 9(c) of the Act provides that the Commission shall grant an application for exemption from the disqualification provisions of section 9(a) of the Act if it is established that these provisions, as applied to Applicants, are unduly or disproportionately severe or that the conduct of the Applicants has been such as not to make it against the public interest or the protection of investors to grant the exemption. Applicants have filed an application pursuant to section 9(c) seeking a temporary and permanent order exempting the Applicants and the other Covered Persons from the disqualification provisions of section 9(a).

3. Applicants believe that they meet the standards for exemption specified in section 9(c). Applicants state that the prohibitions of section 9(a) as applied to them would be unduly

and disproportionately severe and that the conduct of Applicants has been such as not to make it against the public interest or the protection of investors to grant the requested exemption from section 9(a).

4. Applicants state that the alleged conduct giving rise to the Injunction did not involve any of the Applicants acting as an investment adviser or depositor of any registered investment company or ESC, or principal underwriter for any open-end Fund, registered unit investment trust or registered face-amount certificate company ("Fund Service Activities"). Applicants note that (i) none of the current or former directors, officers, or employees of the Applicants (other than UBSFS) had any knowledge of, or had any involvement in, the conduct alleged in the Complaint; and (ii) the personnel at UBSFS who were involved in the violations alleged in the Complaint are no longer employed by UBSFS. Applicants further note that the business unit in which the former employees were employed was closed by UBSFS in June 2008. Applicants state that the personnel at UBSFS who were involved in the violations alleged in the Complaint have had no and will not have any future involvement in the Covered Persons' activities in any capacity described in section 9(a) of the Act.

5. Applicants state that the inability of the Applicants to engage in Fund Service Activities would result in potentially severe financial hardships for the registered investment companies they serve and the registered investment companies' shareholders or unitholders. Applicants state that they will distribute written materials, including an offer to meet in person to discuss the materials, to the boards of directors of the Funds (the "Boards"), including the directors who are not "interested persons," as defined in section 2(a)(19) of the Act, of such Funds, and their independent legal counsel as defined in rule 0-1(a)(6) under the Act, if any, regarding the Injunction, any impact on the Funds, and the application. Applicants state that they will provide the Boards with all information concerning the Injunction and the application that is

necessary for the Funds to fulfill their disclosure and other obligations under the federal securities laws.

6. Applicants also state that, if they were barred from providing Fund Service Activities to registered investment companies and ESCs, the effect on their businesses and employees would be severe. Applicants state that they have committed substantial resources to establish an expertise in providing Fund Service Activities. Applicants further state that prohibiting them from providing Fund Service Activities would not only adversely affect their businesses, but would also adversely affect approximately 550 employees that are involved in those activities. Applicants also state that disqualifying UBS AG and ESC GP from continuing to provide investment advisory services to ESCs is not in the public interest or in furtherance of the protection of investors. Because the ESCs have been formed for the benefit of key employees, officers, directors and current consultants of UBS AG and its affiliates, it would not be consistent with the purposes of the ESC provisions of the Act to require another entity not affiliated with UBS AG to manage the ESCs. In addition, participants in the ESCs have subscribed for interests in the ESCs with the expectation that the ESCs would be managed by an affiliate of UBS AG.

7. Applicants state that Applicants and certain other affiliated persons of UBSFS have previously received orders under section 9(c) of the Act, as the result of conduct that triggered section 9(a), as described in greater detail in the application.

Applicants' Condition:

Applicants agree that any order granting the requested relief will be subject to the following condition:

Any temporary exemption granted pursuant to the application shall be without prejudice to, and shall not limit the Commission's rights in any manner with respect to, any Commission investigation of, or administrative proceedings involving or against, Covered Persons, including without limitation, the consideration by the Commission of a permanent exemption from section 9(a) of the Act requested pursuant to the application or the revocation or removal of any temporary exemptions granted under the Act in connection with the application.

Temporary Order:

The Commission has considered the matter and finds that the Applicants have made the necessary showing to justify granting a temporary exemption.

Accordingly,

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that Applicants and any other Covered Persons are granted a temporary exemption from the provisions of section 9(a), solely with respect to the Injunction, subject to the condition in the application, from May 6, 2011, until the Commission takes final action on their application for a permanent order.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64449 / May 10, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14376**

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| **In the Matter of**<br><br>**Diversified Investors Corp. (n/k/a Diverse Holdings Corp.),**<br>**Drew Resources, Inc. (n/k/a Galloway Energy, Inc.),**<br>**DTI Medical Corp.,**<br>**DTLL, Inc. (n/k/a Solstice Resorts, Inc.), and**<br>**Dunn's Supply Store, Inc.,**<br><br>**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 Diversified Investors Corp (n/k/a Diverse Holdings Corp.), Drew Resources, Inc. (n/k/a Galloway Energy, Inc.), DTI Medical Corp., DTLL, Inc. (n/k/a Solstice Resorts, Inc.), and Dunn's Supply Store, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Diversified Investors Corp. (n/k/a Diverse Holdings Corp.) (CIK No. 724839) is a void Delaware corporation located in Salt Lake City, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Diversified Investors 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, 2000,

which reported a net loss of over $21,000 for the prior nine months. As of May 3, 2011, the company's stock (symbol "DVRH") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Drew Resources, Inc. (n/k/a Galloway Energy, Inc.) (CIK No. 1110448) is a Nevada corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Drew Resources is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001, which reported a net loss of over $13,000 for the prior three months. As of May 3, 2011, the company's stock (symbol "GWGI") was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. DTI Medical Corp. (CIK No. 718247) is an expired Utah company located in San Antonio, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DTI Medical 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, 1997, which reported a net loss of over $32,000 for the prior nine months. On May 12, 1998, DTI Medical filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Texas, and the case was terminated on July 21, 1998. As of May 3, 2011, the company's stock (symbol "DTIM") 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. DTLL, Inc. (n/k/a Solstice Resorts, Inc.) (CIK No. 356767) is an inactive Minnesota corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DTLL 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, 2007, which reported a net loss of over $2.6 million for the prior nine months. As of May 3, 2011, the company's stock (symbol "SOSR") 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. Dunn's Supply Store, Inc. (CIK No. 916357) is a dissolved Tennessee corporation located in Grand Junction, Tennessee with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Dunn's Supply Store is delinquent in its periodic filings with the Commission, having not filed any compliant periodic reports since it filed a Form 10-K for the period ended May 31, 1996, which reported a net loss of over $1.45 million for the prior twelve months. As of May 3, 2011, the company's stock (symbol "DUNS") was quoted on OTC Link, had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rules 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 domestic 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

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

**May 10, 2011**

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|---|---|
| **In the Matter of**<br><br>**Diversified Investors Corp. (n/k/a Diverse Holdings Corp.),**<br>**Drew Resources (n/k/a Galloway Energy, Inc.),**<br>**DTI Medical Corp.,**<br>**DTLL, Inc. (n/k/a Solstice Resorts, Inc.), and**<br>**Dunn's Supply Store, Inc.,**<br><br>**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 Diversified Investors Corp. (n/k/a Diverse Holdings Corp.) because it has not filed any periodic reports since the period ended August 31, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Drew Resources (n/k/a Galloway Energy, Inc.) because it has not filed any periodic reports since the period ended March 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of DTI Medical Corp. because it has not filed any periodic reports since the period ended September 30, 1997.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities DTLL, Inc. (n/k/a Solstice

Resorts, Inc. because it has not filed any periodic reports since the period ended September 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Dunn's Supply Store, Inc. because it has not filed any periodic reports since it filed a registration statement on May 31, 1996.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on May 10, 2011, through 11:59 p.m. EDT on May 23, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA-3198; File No. S7-17-11]

RIN 3235-AK71

**Investment Adviser Performance Compensation**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule; notice of intent to issue order.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") intends to issue an order that would adjust two dollar amount tests in the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge performance based compensation to "qualified clients." The adjustments would revise the dollar amount tests to account for the effects of inflation. The Commission is also proposing to amend the rule to: provide that the Commission will issue an order every five years adjusting for inflation the dollar amount tests; exclude the value of a person's primary residence from the test of whether a person has sufficient net worth to be considered a "qualified client;" and add certain transition provisions to the rule.

**DATES:** Comments on the proposed rule should be received on or before July 11, 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); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-17-11 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 S7-17-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.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 available publicly.

**HEARING REQUEST:** An order adjusting the dollar amount tests specified in the definition of "qualified client" will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary. Hearing requests should be received by the SEC by 5:30 p.m. on June 20, 2011. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested.

**FOR FURTHER INFORMATION CONTACT:** Adam B. Glazer, Senior Counsel, or C. Hunter Jones, Assistant Director, at 202-551-6792, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** The Commission intends to issue an order, and is proposing for public comment amendments to rule 205-3 [17 CFR 275.205-3], under the Investment Advisers Act of 1940 ("Advisers Act" or "Act").[1]

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## I. BACKGROUND

Section 205(a)(1) of the Investment Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client.[2] Congress prohibited these compensation arrangements (also known as performance compensation or performance fees) in 1940 to protect advisory clients from arrangements it believed might encourage advisers to take undue risks with client

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1 15 U.S.C. 80b. Unless otherwise noted, all references to statutory sections are to the Investment Advisers Act, and all references to rules under the Investment Advisers Act, including rule 205-3, are to Title 17, Part 275 of the Code of Federal Regulations [17 CFR 275].

2 15 U.S.C. 80b-5(a)(1).

funds to increase advisory fees.[3] In 1970, Congress provided an exception from the prohibition for advisory contracts relating to the investment of assets in excess of $1,000,000,[4] if an appropriate "fulcrum fee" is used.[5] Congress subsequently authorized the Commission to exempt any advisory contract from the performance fee prohibition if the contract is with persons that the Commission determines do not need the protections of that prohibition.[6]

The Commission adopted rule 205-3 in 1985 to exempt an investment adviser from the prohibition against charging a client performance fees in certain circumstances.[7] The rule, when

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3 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees were characterized as "heads I win, tails you lose" arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. Rep No. 1775, 76th Cong., 3d Sess. 22 (1940).

4 15 U.S.C. 80b-5(b)(2). Trusts, governmental plans, collective trust funds, and separate accounts referred to in section 3(c)(11) of the Investment Company Act of 1940 [15 U.S.C. 80a-3(c)(11)] are not eligible for this exception from the performance fee prohibition under section 205(b)(2)(B) of the Advisers Act.

5 15 U.S.C. 80b-5(b). A fulcrum fee generally involves averaging the adviser's fee over a specified period and increasing or decreasing the fee proportionately with the investment performance of the company or fund in relation to the investment record of an appropriate index of securities prices. *See* rule 205-2 under the Advisers Act; Definition of "Specified Period" Over Which Asset Value of Company or Fund Under Management is Averaged, Investment Advisers Act Release No. 347 (Nov. 10, 1972) [37 FR 24895 (Nov. 23, 1972)]. In 1980, Congress added another exception to the prohibition against charging performance fees, for contracts involving business development companies under certain conditions. *See* section 205(b)(3) of the Advisers Act.

6 Section 205(e) of the Advisers Act. In 1996, Congress included in the National Securities Markets Improvement Act of 1996 ("1996 Act") two additional statutory exceptions from the performance fee prohibition and new section 205(e) of the Advisers Act. The 1996 Act added exceptions for contracts with companies excepted from the definition of "investment company" in the Investment Company Act of 1940 ("Investment Company Act") [15 U.S.C. 80a] by section 3(c)(7) of the Investment Company Act [15 U.S.C. 80a-3(c)(7)] and contracts with persons who are not residents of the United States. *See* sections 205(b)(4) and (b)(5). Section 205(e) of the Advisers Act authorizes the Commission to exempt conditionally or unconditionally from the performance fee prohibition advisory contracts with persons that the Commission determines do not need its protections. Section 205(e) provides that the Commission may determine that persons do not need the protections of section 205(a)(1) on the basis of such factors as "financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with [section 205]."

7 Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act

adopted, allowed an adviser to charge performance fees if the client had at least $500,000 under management with the adviser immediately after entering into the advisory contract ("assets-under-management test") or if the adviser reasonably believed the client had a net worth of more than $1 million at the time the contract was entered into ("net worth test"). The Commission stated that these standards would limit the availability of the exemption to clients who are financially experienced and able to bear the risks of performance fee arrangements.[8]

In 1998, the Commission amended rule 205-3 to, among other things, change the dollar amounts of the assets-under-management test and net worth test to adjust for the effects of inflation since 1985.[9] The Commission revised the former from $500,000 to $750,000, and the latter from $1 million to $1.5 million.[10]

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[11] The Dodd-Frank Act, among other things, amended section 205(e) of the Advisers Act to state that, by July 21, 2011 and every five years thereafter, the Commission shall adjust for inflation the dollar amount tests included in rules issued under section 205(e).[12] Separately, the Dodd-Frank Act also required that we adjust the

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Release No. 996 (Nov. 14, 1985) [50 FR 48556 (Nov. 26, 1985)] ("1985 Adopting Release"). The exemption applies to the entrance into, performance, renewal, and extension of advisory contracts. *See* rule 205-3(a).

8 *See* 1985 Adopting Release, *supra* note 7, at Sections I.C and II.B. The rule also imposed other conditions, including specific disclosure requirements and restrictions on calculation of performance fees. *See id.* at Sections II.C – E.

9 *See* Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 1731 (July 15, 1998) [63 FR 39022 (July 21, 1998)] ("1998 Adopting Release").

10 *See id.* at Section II.B.1.

11 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

12 *See* section 418 of the Dodd-Frank Act (requiring the Commission to issue an order every five years revising dollar amount thresholds in a rule that exempts a person or transaction from section 205(a)(1) of the Advisers Act if the dollar amount threshold was a factor in the Commission's

net worth standard for an "accredited investor" in rules under the Securities Act of 1933 ("Securities Act")[13] to exclude the value of a person's primary residence.[14]

## II. Discussion

Pursuant to section 418 of the Dodd-Frank Act, today we are providing notice that the Commission intends to issue an order revising the dollar amount tests of rule 205-3 to account for the effects of inflation. We also are proposing for public comment amendments to rule 205-3 to provide that the Commission will subsequently issue orders making future inflation adjustments every five years.[15] In addition, we are proposing to amend rule 205-3 to exclude the value of a person's primary residence from the determination of whether a person meets the net worth standard required to qualify as a "qualified client." Finally, we propose to modify the transition provisions of the rule to take into account performance fee arrangements that were permissible when they were entered into, so that new dollar amount thresholds do not require investment advisers to renegotiate the terms of arrangements that were permissible when the parties entered into them. These proposals are discussed in more detail below.

### A. Order Adjusting Dollar Amount Tests

We intend to issue an order revising the dollar amounts of the assets-under-management test and the net worth test in the definition of "qualified client" in rule 205-3. As discussed above, the Commission last revised these dollar amount tests in 1998 to take into account the effects of inflation. At that time, the Commission revised the assets-under-management test from $500,000 to $750,000 and revised the net worth test from $1 million to $1.5 million.

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determination that the persons do not need the protections of that section).

13 15 U.S.C. 77a *et seq.*

14 *See* section 413(a) of the Dodd-Frank Act.

15 Rule 205-3 is the only exemptive rule issued under section 205(e) of the Advisers Act that includes dollar amount tests, which are the assets-under-management and net worth tests.

Pursuant to section 418 of the Dodd-Frank Act, which requires that we revise the dollar amount thresholds of the rule by order not later than July 21, 2011, and every five years thereafter, today we are providing notice[16] that we intend to issue an order to revise the assets-under-management and net worth tests of rule 205-3 to $1 million[17] and $2 million respectively.[18]

These revised dollar amounts would take into account the effects of inflation by reference to the historic and current levels of the Personal Consumption Expenditures Chain-Type Price Index ("PCE Index"),[19] which is published by the Department of Commerce.[20] The PCE Index is often used as an indicator of inflation in the personal sector of the U.S. economy.[21] The

16 *See* section 211(c) of the Advisers Act (requiring the Commission to provide appropriate notice of and opportunity for hearing for orders issued under the Advisers Act).

17 An investment adviser could include in determining the amount of assets under management the assets that a client is contractually obligated to invest in private funds managed by the adviser. Only bona fide contractual commitments may be included, *i.e.*, those that the adviser has a reasonable belief that the investor will be able to meet.

This approach to calculating assets under management conforms with the approach we took in our recent release proposing to implement certain exemptions from registration with the Commission under the Advisers Act. In that release, we proposed to include uncalled capital commitments in the calculation of assets under management used to determine whether an adviser qualifies for the private fund adviser exemption. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111 (Nov. 19, 2010) [75 FR 77190 (Dec. 10, 2010)] at nn.192-94 and accompanying text.

18 As discussed further below, we also would revise the definition of "qualified client" in rule 205-3(d) to reflect the updated thresholds.

19 The revised dollar amounts in the tests would reflect inflation as of the end of 2010, and are rounded to the nearest $100,000 as required by section 418 of the Dodd-Frank Act. The 2010 PCE Index is 111.123, and the 1997 PCE Index was 85.395. Assets-under-management test calculation to adjust for the effects of inflation: 111.123/85.395 x $750,000 = $975,962; $975,962 rounded to the nearest multiple of $100,000 = $1 million. Net worth test calculation to adjust for the effects of inflation: 111.123/85.395 x $1.5 million = $1,951,923; $1,951,923 rounded to the nearest multiple of $100,000 = $2 million.

20 The values of the PCE Index are available from the Bureau of Economic Analysis, a bureau of the Department of Commerce. *See http://*www.bea.gov. *See also http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=64&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=1997&LastYear=2010&3Place=N&Update=Update&JavaBox=no#Mid*.

21 *See* Clinton P. McCully, Brian C. Moyer, and Kenneth J. Stewart, "Comparing the Consumer

Commission has used the PCE Index in other contexts, including the determination of whether a person meets a specific net worth minimum in Regulation R under the Securities Exchange Act of 1934 (15 U.S.C. 78a) ("Exchange Act").[22]

**B. Proposed Amendments to Rule 205-3**

*1. Inflation Adjustment of Dollar Amount Thresholds*

We also are proposing to amend rule 205-3 under the Advisers Act. We would add a new paragraph (e) stating that the Commission will issue an order every five years adjusting for inflation the dollar amounts of the assets-under-management and net worth tests of the rule, as required by the Dodd-Frank Act.[23] Our proposed amendment would specify that the PCE Index will be the inflation index used to calculate future inflation adjustments of the dollar amount tests in the rule.[24] We believe the use of the PCE Index is appropriate because, as discussed above, it

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Price Index and the Personal Consumption Expenditures Price Index," Survey of Current Business (Nov. 2007) at 26 n.1 (PCE Index measures changes in "prices paid for goods and services by the personal sector in the U.S. national income and product accounts" and is primarily used for macroeconomic analysis and forecasting). *See also* FEDERAL RESERVE BOARD, MONETARY POLICY REPORT TO THE CONGRESS (Feb. 17, 2000) at n.1 (available at http://www.federalreserve.gov/boarddocs/hh/2000/february/ReportSection1.htm#FN1) (noting the reasons for using the PCE Index rather than the consumer price index).

22 *See* Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Securities Exchange Act Release No. 56501 (Sept. 24, 2007) [72 FR 56514 (Oct. 3, 2007)] ("Regulation R Release") (adopting periodic inflation adjustments to the fixed-dollar thresholds for both "institutional customers" and "high net worth customers" under Rule 701 of Regulation R). *See also* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) [75 FR 49234 (Aug. 12, 2010)] (increasing for inflation the threshold amount for prepayment of advisory fees that triggers an adviser's duty to provide clients with an audited balance sheet and the dollar threshold triggering the exception to the delivery of brochures to advisory clients receiving only impersonal advice). The Dodd-Frank Act also requires the use of the PCE Index to calculate inflation adjustments for the cash limit protection of each investor under the Securities Investor Protection Act of 1970. *See* section 929H(a) of the Dodd-Frank Act.

23 Proposed rule 205-3(e) would provide that the Commission will issue an order effective on or about May 1, 2016 and approximately every five years thereafter adjusting the assets-under-management and net worth tests for the effects of inflation.

24 Proposed rule 205-3(e) would provide that the assets-under-management and net worth tests will be adjusted for inflation by (i) dividing the year-end value of the PCE Index for the calendar year

is an indicator of inflation in the personal sector of the U.S. economy and is used in other provisions of the federal securities laws.[25] We also intend to revise paragraph (d) of rule 205-3, which sets forth the assets-under-management and net worth tests, to reflect the revised thresholds that we establish by the order discussed above.[26] Finally, we anticipate that, if we adopt these proposed amendments to rule 205-3, we would delegate to our staff the authority to issue inflation adjustment orders every five years in the future.[27]

We request comment on the proposed amendments to rule 205-3 concerning the adjustment of the dollar amount thresholds to account for inflation.

- Is the proposed use of the PCE Index as a measure of inflation appropriate? Is there another index or other measure that would be more appropriate?
- The rule would establish the dollar amount tests we adopted in 1998 as the baseline for all future adjustments, as a consistent denominator for all future calculations. Should we instead establish each future adjustment of the dollar amount tests as a

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preceding the calendar year in which the order is being issued, by the year-end value of the PCE Index for the calendar year 1997, (ii) multiplying the threshold amounts adopted in 1998 ($750,000 and $1.5 million) by that quotient, and (iii) rounding each product to the nearest multiple of $100,000. For example, for the order the Commission would issue in 2016, the Commission would (i) divide the 2015 PCE Index by the 1997 PCE Index, (ii) multiply the quotient by $750,000 and $1.5 million, and (iii) round each of the two products to the nearest $100,000.

25 *See supra* notes 21-22 and accompanying text.

26 As discussed above, we would revise the assets-under-management test to $1 million and the net worth test to $2 million.

27 To delegate this authority to the staff, we would amend our rules of organization and program management to delegate to the Director of the Division of Investment Management the authority to issue notices and orders revising the dollar amount thresholds in rule 205-3(d)(1)(i) (assets-under-management) and 205-3(d)(1)(ii)(A) (net worth) for the effects of inflation pursuant to amended section 205(e) of the Advisers Act every five years after 2011. *See* rule 30-5 of the Commission's Rules of Organization and Program Management [17 CFR 200.30-5] (delegating authority to the Director of the Division of Investment Management). We also anticipate that future changes to the dollar amount tests that are issued by order, will be reflected in technical amendments to rule 205-3(d).

new baseline for the next calculation of the dollar amount tests? If we were to adopt that approach, because the Dodd-Frank Act requires that revised thresholds be rounded to the nearest $100,000, could the establishment of new baselines at the rounded amounts, each time the thresholds are adjusted, result in the underestimation or overestimation of the effects of inflation in subsequent periods?

### 2. *Exclusion of the Value of Primary Residence from Net Worth Determination*

We also are proposing to amend the net worth standard in rule 205-3, in the definition of "qualified client," to exclude the value of a natural person's primary residence and debt secured by the property.[28] This change, although not required by the Dodd-Frank Act, is similar to that Act's requirement that we exclude the value of a natural person's primary residence in the definition of "accredited investor" in rules under the Securities Act.[29] The value of a person's residence may have little relevance to an individual's financial experience[30] and ability to bear

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28 Proposed rule 205-3(d)(1)(ii)(A) (excluding from the assessment of net worth the value of a natural person's primary residence "calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property").

29 *See* section 413(a) of the Dodd-Frank Act (requiring the Commission to adjust any net worth standard for an "accredited investor" as set forth in Commission rules under the Securities Act of 1933 to exclude the value of a natural person's primary residence). The Dodd-Frank Act does not require that the net worth standard for an accredited investor be adjusted periodically for the effects of inflation, although it does require the Commission at least every four years to "undertake a review of the definition, in its entirety, of the term 'accredited investor' … [as defined in Commission rules] as such term applies to natural persons, to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy." *See* section 413(b)(2)(A) of the Dodd-Frank Act. In a separate release, we proposed rule amendments to adjust the net worth standards for accredited investors in our rules under the Securities Act. *See* Net Worth Standard for Accredited Investors, Securities Act Release No. 9177 (Jan. 25, 2011) [76 FR 5307 (Jan. 31, 2011)] ("Accredited Investor Proposing Release").

30 We stated in 2006, when we proposed a minimum net worth threshold for establishing when an individual could invest in hedge funds pursuant to the safe harbor of Regulation D, that the value of an individual's personal residence may bear little or no relationship to that person's financial knowledge and sophistication. *See* Prohibition of Fraud by Advisers to Certain Pooled

the risks of performance fee arrangements, and therefore little relevance to the individual's need for the Act's protections from performance fee arrangements.[31] The Commission took a similar approach when it excluded the value of a person's primary residence and associated liabilities from the determination of whether a person is a "high net worth customer" in Regulation R under the Exchange Act[32] and from the determination of whether a natural person has a sufficient level of investments to be considered a "qualified purchaser" under the Investment Company Act.[33]

Our proposed amendment would exclude the value of a natural person's primary residence *and* the amount of debt secured by the property that is no greater than the property's current market value.[34] Therefore a mortgage on the residence would not be included in the assessment of a natural person's net worth, unless the outstanding debt on the mortgage, at the time that net worth is calculated, exceeds the market value of the residence. If the outstanding debt exceeds the market value of the residence, the amount of the excess would be considered a liability in calculating net worth under the proposed amendments to rule 205-3.

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Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Investment Advisers Act Release No. 2576 (Dec. 27, 2006) [72 FR 400 (Jan. 4, 2007)] at Section III.B.3.

31 For example, an individual who meets the net worth test only by including the value of his primary residence in the calculation is unlikely to be as able to bear the risks of performance fee arrangements as an individual who meets the test *without* including the value of her primary residence.

32 *See, e.g.*, Regulation R Release, *supra* note 22, at Section II.C.1 (excluding primary residence and associated liabilities from the fixed-dollar threshold for "high net worth customers" under Rule 701 of Regulation R, which permits a bank to pay an employee certain fees for the referral of a high net worth customer or institutional customer to a broker-dealer without requiring registration of the bank as a broker-dealer).

33 A qualified purchaser under section 2(a)(51) of the Investment Company Act [15 U.S.C. 80a-2(a)(51)] includes, among others, any natural person who owns not less than $5 million in investments, as defined by the Commission. Rule 2a51-1 under the Investment Company Act includes within the meaning of investments real estate held for investment purposes. 17 CFR 270.2a51-1(b)(2). A personal residence is not considered an investment under rule 2a51-1, although residential property may be treated as an investment if it is not treated as a residence for tax purposes. *See* Privately Offered Investment Companies, Investment Company Act Release No. 22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)] at text accompanying and following n.48.

34 Proposed rule 205-3(d)(1)(ii)(A).

We request comment on the proposed exclusion of the value of a person's primary residence from the calculation of a natural person's net worth under rule 205-3.

- Should we, as proposed, exclude the value of a natural person's primary residence from the calculation of net worth? Or should we include the value of a person's primary residence? Does such ownership evidence financial experience and the ability to bear risks associated with performance fee contracts? Should we, as proposed, also exclude from the net worth standard in rule 205-3 debt secured by a person's primary residence, up to the market value of the residence? Does such debt affect the ability to bear risks associated with performance fee contracts or investments that often are associated with such contracts?
- We note that although the Dodd-Frank Act requires the Commission to exclude a natural person's primary residence from the net worth standard for an "accredited investor" in rules under the Securities Act, the Dodd-Frank Act does not require the Commission to exclude a natural person's primary residence from the standards for a "qualified client" in rules under section 205(e) of the Advisers Act. Instead, the Dodd-Frank Act requires that the dollar amount tests of "qualified client" be adjusted for inflation every five years. Should our amendment of rule 205-3 accomplish only what the Dodd-Frank Act mandates (*i.e.*, inflation-adjustment of the dollar amount tests) and not revise the net worth test by excluding the value of a primary residence?
- Should the rule require, as proposed, that debt secured by the residence in excess of the market value of the residence at the time the advisory contract is entered into be included as a liability in the determination of the person's net worth? Should the rule instead require that *all* debt that is secured by the primary residence (regardless of

whether it exceeds the fair market value of the residence) be excluded from the calculation of net worth under rule 205-3? Alternatively, should the rule exclude the entire market value of the residence from net worth, but require treatment of any associated debt as a liability? Should the rule require inclusion of debt secured by a primary residence as a liability if proceeds of the debt are used to enter into an advisory contract that involves performance compensation paid to an investment adviser? If so, how would these proceeds of the debt be traced?

- Should the rule provide that the calculation of net worth must be made on a specified date prior to the day the advisory contract is entered into, for example 30, 60, or 90 days? If not, would investors be likely to inflate their net worth by borrowing against their homes to attain qualified client status? If we were to require that the net worth calculation be made a significant period of time in advance of entering into the advisory contract, would such a requirement make the calculation unduly complex?
- Is the language of the proposed rule amendment sufficiently precise? Should we substitute the word "equity" for the word "value" when referring to the primary residence excluded from the calculation of a natural person's net worth? Should we define the term "primary residence" for purposes of rule 205-3? If so, should we address the circumstances of a person who lives in multiple residences for roughly equal amounts of time during the year?[35]

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[35] As we stated in the Accredited Investor Proposing Release, *supra* note 29, at nn.35-36 and accompanying text, helpful guidance may be found in rules that apply in other contexts. For example, the IRS Publication 523, *Selling Your Home* 3-4 (Jan. 5, 2011) lists the following factors to be used, in addition to the amount of time a person lives in each of several homes, to determine a person's "principal residence" under section 121 of the Internal Revenue Code, 26 U.S.C. 121: place of employment; location of family members' main home; mailing address for bills and correspondence; address listed on federal and state tax returns, driver's license, car registration, and voter registration card; location of banks used and recreational clubs and

- As noted above, the Commission proposed in a separate release to adjust the net worth standards for accredited investors in our rules under the Securities Act, to exclude the value of a natural person's primary residence from the assessment of a natural person's net worth.[36] We request comment on whether the net worth standards that we consider in connection with rule 205-3 should differ from any standards we consider in connection with those proposed amendments.

### 3. *Transition Rules*

The proposed amendments would replace the current transition rules section of rule 205-3 with two new subsections to allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. These transition provisions, proposed rules 205-3(c)(1) and (2), are both designed so that restrictions on the charging of performance fees apply to new contractual arrangements and do not apply retroactively to existing contractual arrangements, including investments in companies that are excluded from the definition of an "investment company" under the Investment Company Act by reason of section 3(c)(1)[37] of that Act ("private investment companies").[38] This approach would minimize the disruption of existing contracts that meet

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religious organizations.

36 *See supra* note 29.

37 *See* rule 205-3(d)(3) (defining "private investment company" for purposes of rule 205-3). Advisory contracts with companies excepted from the definition of an "investment company" by reason of section 3(c)(7) of the Investment Company Act are not subject to the Advisers Act performance fee prohibition. *See* section 205(b)(4) of the Advisers Act. Therefore these contractual arrangements do not need, and are not included within, the exemptive relief provided by rule 205-3.

38 Under rule 205-3(b), the equity owner of a private investment company, or of a registered investment company or business development company, is considered a client of the adviser for purposes of rule 205-3(a). We adopted this provision in 1998, and the provision was not affected

applicable standards at the time the parties entered into the contract.

First, proposed rule 205-3(c)(1) would provide that, if a registered investment adviser entered into a contract and satisfied the conditions of the rule that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of the rule.[39] If, however, a natural person or company that was not a party to the contract becomes a party, the conditions of the rule in effect at the time they become a party would apply to that person or company. This proposed subsection would mean, for example, that if an individual meets the $1.5 million net worth test and enters into an advisory contract with a registered investment adviser, the client could continue to maintain funds (and invest additional funds) with the adviser under that contract even if the net worth test were subsequently raised and he or she no longer met the new test. If, however, another person were to become a party to that contract, the current net worth threshold would apply to the new party when he or she becomes a party to the contract.[40]

We request comment on this proposed transition provision.

- Should the rule be amended as proposed, to allow advisers to continue to provide advisory services under performance fee arrangements that were permitted under the rule in effect at the time the contract was entered into, if the client does not meet the

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by our subsequent rule amendments and related litigation concerning the registration of investment advisers to private investment companies. *See* 1998 Adopting Release, *supra* note 9; Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006).

39 Proposed rule 205-3(c)(1) would modify the existing transition rule in rule 205-3(c)(1), which permits advisers and their clients that entered into a contract before August 20, 1998, and satisfied the eligibility criteria in effect on the date the contract was entered into to maintain their existing performance fee arrangements.

40 Proposed rule 205-3(c)(1). Similarly, a person who invests in a private investment company advised by a registered investment adviser must satisfy the rule's conditions when he or she becomes an investor in the company. *See* rule 205-3(b) (equity owner of a private investment company is considered a client of a registered investment adviser for purposes of rule 205-3(a)).

eligibility criteria after an adjustment to the dollar amount tests or for any other reason (*e.g.*, a decrease in the client's net worth below the dollar amount test)? Should the rule in these circumstances permit the management of existing funds under previous contractual arrangements, but prohibit an adviser from charging performance fees with respect to funds committed after the effective date of the rule? If so, how should the rule treat dividends and realized capital gains reinvested by the adviser?

Second, proposed rule 205-3(c)(2) would provide that, if an investment adviser was previously exempt pursuant to section 203 from registration with the Commission and subsequently registers with the Commission, section 205(a)(1) of the Act would not apply to the contractual arrangements into which the adviser entered when it was exempt from registration with the Commission.[41] This proposed subsection would mean, for example, that if an investment adviser to a private investment company with 50 individual investors was exempt from registration with the Commission in 2009, but then subsequently registered with the Commission because it was no longer exempt from registration or because it chose voluntarily to register, section 205(a)(1) would not apply to the contractual arrangements the adviser entered into before it registered, including the accounts of the 50 individual investors with the private investment company and any additional investments they make in that company. If, however, any other individuals become new investors in the private investment company after the adviser

41 Section 205(a)(1) would apply, however, to contractual arrangements into which the adviser enters after it is no longer exempt from registration with the Commission. *See* proposed rule 205-3(c)(2). The approach of the proposed subsection is similar to the transition subsections we adopted in 2004, in rules 205-3(c)(2) - (3), when we adopted rules to require the registration of investment advisers to private funds. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)]. Those transition provisions were vacated by the U.S. Court of Appeals for the District of Columbia Circuit when it vacated the Commission's rulemaking in its entirety. *See* Goldstein v. SEC, *supra* note 38.

registers with the Commission, section 205(a)(1) would apply to the adviser's relationship with them.

We request comment on this proposed transition provision.

- Should the rule be amended as proposed, to allow advisers to continue to be compensated under performance fee arrangements that were permitted when the adviser was exempt from registration with the Commission? Should the rule in these circumstances permit the management of existing funds under previous contractual arrangements, but prohibit a newly registered investment adviser from charging a performance fee with respect to any *additional* funds to be managed under previously existing contracts?
- Should the rule differentiate between the reasons why an adviser was exempt from registration (*e.g.*, due to a particular subsection of the Advisers Act) but is no longer exempt? Should the rule include different transition provisions depending upon the reason why an adviser was exempt from registration but is no longer exempt?

### C. Effective and Compliance Dates

We anticipate that, if we issue the order described above and adopt the rule amendments we are proposing, we will allow an appropriate time period before requiring compliance with the new standards. For rule amendments, the Administrative Procedure Act generally requires at least 30 days prior to the effectiveness of new rules, absent special circumstances.[42]

- We request comment on the transition period or delayed compliance date that would be appropriate for any revised thresholds that we issue by order, or for any rule amendments that we adopt. Should we allow more time than the 30 days required

42 *See* 5 U.S.C. 553(d).

under the Administrative Procedure Act (*e.g.*, 60 days, 90 days, 120 days)?

## III. Request for Comment

The Commission requests comment on the rule amendments we propose in this release. Commenters are requested to provide empirical data to support their views. The Commission also requests suggestions for additional changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this release.

## IV. Cost Benefit Analysis

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

In proposing to amend rule 205-3 to provide that the Commission will issue orders every five years adjusting for inflation the dollar amount tests of the rule, we are responding to the Dodd-Frank Act's amendment of section 205(e) of the Advisers Act requiring the Commission to issue these orders.[43] The proposed amendments to rule 205-3 also would exclude the value of a natural person's primary residence and debt secured by the property from the determination of whether a person has sufficient net worth to be considered a "qualified client," and would modify

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43 Section 418 of the Dodd-Frank Act.

the transition provisions of the rule to take into account performance fee arrangements that were permissible when they were entered into.

### A. Benefits

We expect that adjusting the dollar amount thresholds in rule 205-3 for the effects of inflation would benefit advisory clients. When the Commission adopted the dollar amount thresholds in the definition of "qualified client" in rule 205-3 in 1985, it evaluated the most appropriate dollar amount for both the assets-under-management and net worth tests. The Commission stated that these standards would limit the availability of the exemption to clients who are financially experienced and able to bear the risks of performance fee arrangements.[44] The adjustment of these dollar amount tests every five years would carry forward these protections at dollar levels that are based on the current price levels in the economy. We believe that adjusting these eligibility criteria to reflect real dollar equivalents would help to preserve these protections.

The proposed exclusion of the value of an individual's primary residence also would benefit clients. As discussed above, the value of an individual's primary residence may bear little or no relationship to that person's financial experience or ability to bear the risks associated with performance fee arrangements. Therefore, a client who does not meet the net worth test of rule 205-3 without including the value of her primary residence would be protected by the performance fee restrictions in section 205 of the Advisers Act.[45]

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44 *See supra* note 8 and accompanying text.

45 As discussed above, the proposed amendments to rule 205-3 also would exclude from the net worth test the amount of debt secured by the primary residence that is no greater than the property's current market value. The exclusion of the debt might limit these benefits in some circumstances. For example, if a client meets the net worth test as a result of the exclusion of debt secured by the primary residence and the market value of the primary residence were to decline to the extent that the debt could not be satisfied by the sale of the residence, the client might be less able to bear the risks related to the performance fee contract and the investments

The proposed amendments to the rule's transition provisions would benefit advisory clients and investment advisers. The proposed amendments would allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. These transition provisions are designed so that the restrictions on the charging of performance fees apply to new contractual arrangements and do not apply retroactively to existing contractual arrangements, including investments in private investment companies. Otherwise, advisory clients and investment advisers might have to terminate contractual arrangements into which they previously entered and enter into new arrangements, which could be costly to investors and advisers.

- We request comment on these anticipated benefits, and on whether the proposed rule amendments would result in additional benefits to advisory clients and investment advisers.

**B. Costs**

We do not expect that adjusting the dollar amount tests in rule 205-3 would impose significant new costs on advisory clients or investment advisers. As discussed above, section 418 of the Dodd-Frank Act requires the Commission to periodically issue orders adjusting for inflation the assets-under-management and net worth tests in rule 205-3. Raising these eligibility criteria could mean that certain persons who would have qualified under the current dollar amount thresholds would no longer qualify under the dollar amount thresholds as adjusted for the effects of inflation. As a result, an investment adviser could be prohibited from charging performance fees to new clients to whom it could have charged performance fees if the advisory

that the adviser might make on behalf of the client.

contract had been entered into before the adjustment of the dollar amount thresholds. This effect may result in an investment adviser declining to provide services to potential clients.[46] However, this cost is a consequence of the Dodd-Frank Act, and therefore we do not attribute this cost to this rulemaking.

Section 418 of the Dodd-Frank Act does not specify how the Commission should measure inflation. We have proposed to use the PCE Index because it is widely used as a broad indicator of inflation in the economy and because the Commission has used the PCE Index in other contexts. It is possible that the use of the PCE Index to measure inflation might result in a larger or smaller dollar amount for the two thresholds than the use of a different index, although the rounding required by the Dodd-Frank Act (to the nearest $100,000) would likely negate any difference between indexes.

The proposed amendments to the rule's transition provisions are not likely to impose any new costs on advisory clients or investment advisers. As discussed above, the proposed amendments would allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date.

The proposed amendments also would exclude the value of a person's primary residence and debt secured by the property (if no greater than the current market value of the residence) from the calculation of a person's net worth. Based on data from the Federal Reserve Board, approximately 5.5 million households have a net worth of more than $2 million *including* the

46 As discussed above, the proposed amendments would allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. *See supra* Section II.B.3.

equity in the primary residence (*i.e.*, value minus debt secured by the property), and approximately 4.2 million households have a net worth of more than $2 million *excluding* the equity in the primary residence.[47] Therefore, approximately 1.3 million households currently would not meet a $2 million net worth test under the proposed revised test, and would therefore not be considered "qualified clients," if the value of the primary residence is excluded from the test. Excluding the value of the primary residence (and debt secured by the property up to the current market value of the residence) would mean that 1.3 million households that would have met the net worth threshold if the value of the residence were included, as is currently permitted, would no longer be "qualified clients" under the proposed revised net worth test and therefore would be unable to enter into performance fee contracts unless they meet another test of rule 205-3.[48]

As noted above, the proposed amendments would allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into. For purposes of this cost benefit analysis, Commission staff assumes that 25 percent of the 1.3 million households would have entered into *new* advisory contracts that contained performance fee arrangements after the compliance date of the amendments, and therefore approximately 325,000 clients would not meet the revised net worth test.[49] Commission staff estimates that about 40 percent of those 325,000 potential clients (*i.e.*,

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47 These figures are derived from the 2007 Federal Reserve Board Survey of Consumer Finances. These figures represent the net worth of households rather than individual persons who might be clients. More information regarding the survey may be obtained at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

48 The net worth test includes assets that a natural person holds jointly with his or her spouse. *See* rule 205-3(d)(1)(ii)(A).

49 The assumption that 25% of these investors would have entered into *new* performance fee arrangements is based on data compiled in a 2008 report sponsored by the Commission. *See* ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS

130,000) would separately meet the "qualified client" definition under the assets-under-management test, and therefore could enter into performance fee arrangements.[50] The remaining 60 percent (195,000 households) would have access only to those investment advisers (directly or through the private investment companies they manage) that charge advisory fees other than performance fees.[51] Commission staff anticipates that the non-performance fee arrangements into which these clients would enter would contain management fees that yield advisers approximately the same amount of fees that clients would have paid under performance fee arrangements. Under these arrangements, if the adviser's performance does not reach the level at which it would have accrued performance fees, a client might end up paying higher overall fees than if he were paying performance fees. For purposes of this cost benefit analysis, Commission staff assumes that approximately 80 percent of the 195,000 households (*i.e.*, 156,000 households) would enter into these non-performance fee arrangements, and that the other 20 percent would decide not to invest their assets with an adviser.[52]

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AND BROKER-DEALERS 130 (Table C.1) (2008) (available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf) (estimating that approximately 20% of investment advisers charge performance fees). Although that report indicated that 20% of investment advisers charge performance fees and an average of only 37% of investors indicated they would seek investment advisory services in the next five years, *id.* at 105 (Table 6.13), we have used the 25% assumption in an effort to overestimate rather than underestimate the costs, especially given the inherent uncertainty surrounding hypothetical events. As noted above, the estimate concerning 1.3 million households is derived from the 2007 Federal Reserve Board Survey of Consumer Finances. *See supra* notes 47-48 and accompanying text.

50 This estimate is based on data filed by registered investment advisers on Form ADV.

51 Commission staff estimates that less than one percent of registered investment advisers are compensated solely by performance fees, based on data from filings by registered investment advisers on Form ADV.

52 This assumption is based on the idea that a substantial majority of investment advisers that typically charge performance fees and that in the future would calculate a potential client's net worth and determine that it does not meet the $2 million threshold, would offer alternate compensation arrangements in order to offer their services. As noted above, Commission staff

Commission staff estimates that the remaining 39,000 households that would have entered into advisory contracts, if the value of the client's primary residence were not excluded from the calculation of a person's net worth, will not enter into advisory contracts. Some of these households would likely seek other investment opportunities, for example, investing in mutual funds, closed-end funds, or exchange-traded funds. Other households may forgo professional investment management altogether because of the higher value they place on the alignment of advisers' interests with their own interests associated with the use of performance fee arrangements.

We recognize that the proposed amendments that would exclude the value of a person's primary residence from the calculation of a person's net worth also might result in a reduction in the total fees collected by investment advisers. Because advisers would no longer be able to charge some clients performance fees, it is possible that the overall fees collected by advisers might be reduced. As discussed above, advisers may adjust their fees in order to obtain the same revenue from clients who do not meet the definition of "qualified clients." In addition, advisers may choose to market their services to a larger number of potential clients and thereby enter into advisory contracts with others to whom they could charge performance fees.[53] As a result, Commission staff estimates that the proposed amendments are not likely to impose a significant

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estimates that less than one percent of registered advisers charge performance fees exclusively. *See supra* note 51.

53 Commission staff notes that expanding marketing efforts could result in additional costs that offset some of the new sources of revenue. As noted above, Commission staff estimates that 39,000 households that would have entered into advisory contracts would not enter into such contracts as a result of the proposed exclusion of a client's primary residence from a determination of a client's net worth. Based on ADV filings, Commission staff estimates that 3295 registered advisers charge performance fees. Therefore, Commission staff estimates that on average each adviser would need to offset the loss of approximately 12 households (39,000/3295 = 11.8 households) to avoid a reduction in total fees collected, either by charging those households comparable fees other than performance fees, or by attracting other clients that meet the net worth test.

net cost on advisers. Because of the ability of investment advisers to attract qualified clients who satisfy the proposed standards, and the ability of non-qualified clients to invest in other investment opportunities that do not entail performance fees, we expect that the proposed rule would not have a significant impact on capital formation.[54]

We request comment on the economic costs of excluding the value of the primary residence and debt secured by the property from the net worth test for determining whether individual clients are "qualified clients."

- Would most households that no longer meet the net worth standard due to the exclusion of the value of the primary residence, still receive advisory services? Would investment advisers decline to provide advisory services to potential clients who do not qualify as "qualified clients"? Would investment advisers be able to offset the potential lost performance fees? If not, what would be the amount of lost fees that advisers would incur?

### C. Request for Comment

The Commission requests comment on all aspects of the cost benefit analysis, including the accuracy of the potential benefits and costs identified and assessed in this release, as well as any other benefits or costs that may result from the proposals. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or additional benefits and costs. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[55] the Commission also requests information regarding the potential annual effect of the proposals on

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54 Clients who no longer meet the net worth test as a result of the exclusion of their primary residence likely would have invested a smaller amount of assets than other clients who continue to meet the test. Therefore, the revenue loss to investment advisers from the exclusion of these clients from the performance fee exemption may be mitigated.

55 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C., and as a note to 5 U.S.C. 601).

the U.S. economy. Commenters are requested to provide empirical data to support their views.

## V. Paperwork Reduction Act

The proposed amendments to rule 205-3 under the Advisers Act do not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[56] Accordingly, the PRA is not applicable.

## VI. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act of 1980[57] ("RFA") requires the Commission to undertake an initial regulatory flexibility analysis ("IRFA") of the proposed rule amendments on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.[58] Pursuant to 5 U.S.C. section 605(b), the Commission hereby certifies that the proposed amendments to rule 205-3 under the Advisers Act, would not, if adopted, have a significant economic impact on a substantial number of small entities. Under Commission rules, for purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year .[59]

Based on information in filings submitted to the Commission, 617 of the approximately

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[56] 44 U.S.C. 3501-3521.

[57] 5 U.S.C. 603(a).

[58] 5 U.S.C. 605(b).

[59] Rule 0-7(a).

11,888 investment advisers registered with the Commission are small entities. Only approximately 20 percent of the 617 registered investment advisers that are small entities (about 122 advisers) charge any of their clients performance fees. In addition, 24 of the 122 advisers require an initial investment from their clients that would meet the current assets-under-management threshold ($750,000), which advisory contracts would be grandfathered into the exemption provided by rule 205-3 under the proposed amendments. Therefore, if these advisers in the future raise those minimum investment levels to the revised level that we intend to issue by order ($1 million), those advisers could charge their clients performance fees because the clients would meet the assets-under-management test, even if they would not meet the proposed net worth test that would exclude the value of the client's primary residence. For these reasons, the Commission believes that the proposed amendments to rule 205-3 would not, if adopted, have a significant economic impact on a substantial number of small entities.

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

## VII. STATUTORY AUTHORITY

The Commission is proposing amendments to rule 205-3 pursuant to the authority set forth in section 205(e) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-5(e)].

### List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

## TEXT OF PROPOSED RULES

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal

Regulations is proposed to be amended as follows:

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

1. The authority citation for Part 275 continues to read as follows:

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

* * * * *

2. Section 275.205-3 is amended by:

a. Revising paragraph (c);

b. Revising paragraphs (d)(1)(i) and (ii); and

c. Adding paragraph (e).

The revisions and addition read as follows.

**§ 275.205-3 Exemption from the compensation prohibition of section 205(a)(1) for investment advisers.**

* * * * *

(c) *Transition rules.* (1) *Registered investment advisers.* If a registered investment adviser entered into a contract and satisfied the conditions of this section that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of this section; *Provided,* however, that if a natural person or company who was not a party to the contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions of this section in effect at that time will apply with regard to that person or company.

(2) *Registered investment advisers that were previously exempt from registration.* If an investment adviser was exempt from registration with the Commission pursuant to section 203 of the Act (15 U.S.C. 80b-3), section 205(a)(1) of the Act will not apply to an advisory contract

entered into when the adviser was exempt, or to an account of an equity owner of a private investment company advised by the adviser if the account was established when the adviser was exempt; *Provided*, however, that section 205(a)(1) of the Act will apply with regard to a natural person or company who was not a party to the contract and becomes a party (including an equity owner of a private investment company advised by the adviser) when the adviser is no longer exempt.

(d) *Definitions*. For the purposes of this section:

(1) The term qualified client means:

(i) A natural person who, or a company that, immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser;

(ii) A natural person who, or a company that, the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

(A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property; or

(B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)(A)) at the time the contract is entered into; or

* * * * *

(e) *Inflation adjustments.* Pursuant to section 205(e) of the Act, the dollar amounts specified in paragraphs (d)(1)(i) and (d)(1)(ii)(A) of this section shall be adjusted by order of the Commission, effective on or about May 1, 2016 and issued approximately every five years thereafter. The adjusted dollar amounts established in such orders shall be computed by:

(1) Dividing the year-end value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the United States Department of Commerce, for the calendar year preceding the calendar year in which the order is being issued, by the year-end value of such index (or successor) for the calendar year 1997;

(2) For the dollar amount in paragraph (d)(1)(i) of this section, multiplying $750,000 times the quotient obtained in paragraph (e)(1) of this section and rounding the product to the nearest multiple of $100,000; and

(3) For the dollar amount in paragraph (d)(1)(ii)(A) of this section, multiplying $1,500,000 times the quotient obtained in paragraph (e)(1) of this section and rounding the product to the nearest multiple of $100,000.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: May 10, 2011

**SECURITIES AND EXCHANGE COMMISSION**

**Release No. 34-64456; File No. 4-629**

**Solicitation of Comment to Assist in Study on Assigned Credit Ratings**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Request for comment.

**SUMMARY:** The Securities and Exchange Commission ("Commission") requests public comment to assist it in carrying out a study on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization ("SRO") assigns nationally recognized statistical rating organizations ("NRSROs") to determine credit ratings for structured finance products. This study, and a resulting report to Congress, are required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

**DATES:** The Commission will accept comments on matters related to the study on or before [Insert date 120 days from publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-629 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number 4-629. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov). 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 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Randall W. Roy, Assistant Director, at (202) 551-5522; Alan A. Dunetz, Branch Chief, at (212) 336-0072; Kevin S. Davey, Securities Compliance Examiner, at (212) 336-0075; Kristin A. Devitto, Securities Compliance Examiner, at (212) 336-0038; Diane Audino, Securities Compliance Examiner, at (212) 336-0076, or Timothy C. Fox, at (202) 551-5687, Special Counsel, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

## I. BACKGROUND:

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[1] Under Section 939F of the Dodd-Frank Act ("Section 939F"), the Commission must submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, not later than 24 months after the date of enactment of the Dodd-Frank Act, a report containing: (1) the findings of a study on matters related to assigning credit ratings for structured finance products; and (2) any recommendations for regulatory or

[1] Pub. L. No. 111-203, 124 Stat. 1376, H.R. 4173 (2010).

statutory changes that the Commission determines should be made to implement the findings of the study.[2]

Section 939F provides that the Commission, in carrying out the study, shall address four areas. One, the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models.[3] Two, the feasibility of establishing a system in which a public or private utility or an SRO assigns NRSROs to determine the credit ratings for structured finance products, including: (1) an assessment of potential mechanisms for determining fees for NRSROs for structured finance products; (2) appropriate methods for paying fees to NRSROs to rate structured finance products; (3) the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government; and (4) any constitutional or other issues concerning the establishment of such a system.[4] Three, the range of metrics one could use to determine the accuracy of credit

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2 See Section 939F. Section 939F(a) provides that, for purposes of Section 939F, the term "structured finance product" means an "asset-backed security," as defined in Section 3(a)(77) of the Securities Exchange Act of 1934 ("Exchange Act"), as added by Section 941 of the Dodd-Frank Act (15 U.S.C. 78c(a)(77)), and any structured product based on an asset-backed security, as determined by the Commission, by rule. For the purposes of this solicitation of comment, the term "structured finance product" means an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act and, to the extent not included in that definition, any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. See, e.g., 17 CFR 240.17g-2(a)(2)(iii), (a)(7), and (b)(9), 17 CFR 240.17g-3(a)(6), 17 CFR 240.17g-5(a)(3) and (b)(9), and 17 CFR 17g-6(a)(4). See also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR at 63832 (Dec. 4, 2009), at 74 FR 63832, footnote 3.

3 See Pub. L. No. 111-203 § 939F(b)(1).

4 See Pub. L. No. 111-203 § 939F(b)(2)(A) through (B).

ratings for structured finance products.[5] Four, alternative means for compensating NRSROs that would create incentives for accurate credit ratings for structured finance products.[6]

In addition, Section 939F provides that, after submission of the report to Congress resulting from the study, the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system for the assignment of NRSROs to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the NRSRO that will determine the initial credit ratings and monitor such credit ratings.[7] In issuing any rule, the Commission is required to give thorough consideration to the provisions of Section 15E(w) of the Securities Exchange Act of 1934, as that provision would have been added by Section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010 (the "Section 15E(w) Provisions"), and shall implement the system described in such Section 939D (the "Section 15E(w) System") unless the Commission determines that an alternative system would better serve the public interest and the protection of investors.[8]

In carrying out the study required by Section 939F, the Commission believes that comments, proposals, data, and analysis from interested parties representing a wide range views of, and involvement in, the market for structured finance products and the role of NRSROs in that market would provide valuable assistance. In this regard, the Commission seeks comment from: (1) investors and other persons who use credit ratings; (2) participants in pensions funds and other retirement vehicles that may hold structured finance products; (3) portfolio and fund

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5 See Pub. L. No. 111-203 § 939F(b)(3).

6 See Pub. L. No. 111-203 § 939F(b)(4).

7 See Pub. L. No. 111-203 § 939F(d).

8 Id. For ease of reference, the Section 15E(w) Provisions are attached as an Appendix to this solicitation of comments.

managers; (4) investment advisers; (5) insurance companies; (6) credit rating agencies; (7) financial institutions; (8) originators of financial assets that are securitized into structured finance products (including, but not limited to, originators of residential and commercial real estate loans, corporate loans, student loans, credit card receivables, consumer loans and leases, auto loans and leases, auto floor plans, equipment loans and leases, and any other financial assets that are securitized); (9) issuers, underwriters, sponsors, and depositors involved in the issuance of structured finance products; (10) regulators; (11) members of the academic community; and (12) any other persons who have a views concerning, and involvement in, the market for structured finance products and the role of NRSROs in that market. In addition, given the complexity of the issues surrounding the matters to be addressed in the study, the Commission believes an extended comment period of 120 days is appropriate in order to provide sufficient opportunity for all interested parties to consider and respond to the questions and provide any additional comments, proposals, data, and analysis they believe germane to the study.

## II. REQUEST FOR COMMENT

The Commission requests that interested parties provide comments, proposals, data, and analysis in response to the questions below, as appropriate, given their views of, and involvement in, the market for structured finance products and the role of NRSROs in that market.[9] In this regard, the Commission requests that interested parties address the topics and questions set forth in three sections below. Section II.A seeks comment on the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay

[9] The Commission has received a comment that relates to matters in this solicitation of comment as part of its general request for public input on regulatory initiatives under the Dodd-Frank Act. See letter from Anne Simpson of CalPERS dated October 4, 2010. This comment and others relating to credit rating agencies are available at: http://www.sec.gov/comments/df-title-ix/credit-rating-agencies/credit-rating-agencies.shtml.

and the subscriber-pay models.[10] Section II.B seeks comment on the Section 15E(w) System for assigning NRSROs to determine credit ratings for structured finance products. Finally, Section II.C seeks comment on potential alternatives to the Section 15E(w) System.

In addition, the General Accountability Office ("GAO") has developed a framework ("GAO Framework") for Congress and others to use in evaluating or crafting alternative compensation models for NRSROs.[11] The GAO notes that this framework could be used by the Commission to "evaluate current proposals for compensating NRSROs, develop new proposals,

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10 Section 939F(b)(1) requires the Commission to address these matters in carrying out the study. See Pub. L. No. 111-203 § 939F(b)(1).

11 See Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance Related Disclosures, GAO Report 10-782 (September 2010) ("GAO Report 10-782") at pp. 79-93. As discussed below, the GAO Framework consists of a seven factor test to use in evaluating alternative compensation models for NRSROs. Id. The seven factors are: (1) independence (the ability for the compensation model to mitigate conflicts of interest inherent between the entity paying for the rating and the NRSRO); (2) accountability (the ability of the compensation model to promote NRSRO responsibility for the accuracy and timeliness of their ratings); (3) competition (the extent to which the compensation model creates an environment in which NRSROs compete for customers by producing higher-quality ratings at competitive prices); (4) transparency (the accessibility, usability, and clarity of the compensation model and the dissemination of information on the model to market participants); (5) feasibility (the simplicity and ease with which the compensation model can be implemented in the securities market); (6) market acceptance and choice (the willingness of the securities market to accept the compensation model, the ratings produced under that model, and any new market players established by the compensation model); and (7) oversight (the evaluation of the model to help ensure it works as intended). Section 939E of the Dodd-Frank requires the GAO to conduct a study on alternative means for compensating NRSROs in order to create incentives for NRSROs to provide more accurate credit ratings, including any statutory changes that would be required to facilitate the use of an alternative means of compensation. See Pub. L. No. 111-203 § 939E. Section 939E further requires the GAO to provide the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, not later than 18 months after the date of enactment of the Dodd-Frank Act, a report on the results of the study, including recommendations, if any, for providing incentives to credit rating agencies to improve the credit rating process. Id.

and identify trade-offs among them" in carrying out the study required by Section 939F.[12] Consequently, the Commission requests in Sections II.B and II.C that interested parties use the GAO Framework to evaluate, respectively, the Section 15E(w) System and potential alternatives to that system, including alternatives not identified in this release.[13]

Finally, the Commission notes that 10 credit rating agencies currently are registered as NRSROs, eight of which are registered in the class of credit rating for issuers of asset-backed securities.[14] Based on information disclosed by these eight NRSROs in their most recently updated Form NRSROs, the Commission estimates that approximately 94% of the outstanding credit ratings for structured finance products were determined by the three largest NRSROs (see Figure 1 below).[15] The Commission requests that interested parties, in responding to the topics and questions below address, as applicable, the likely impact the proposals would have on the concentration of issuance of credit ratings for structured finance products among NRSROs.

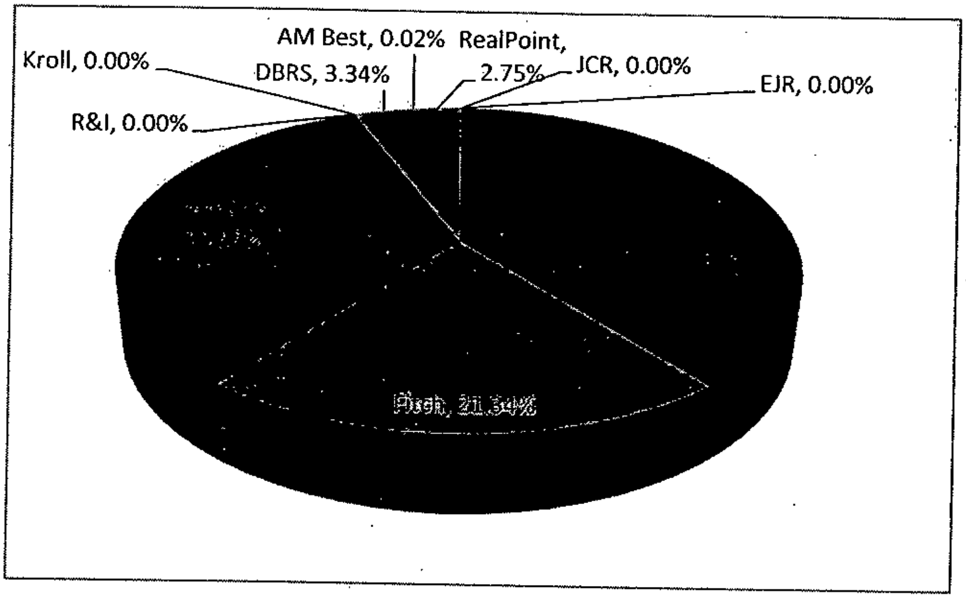
12 GAO Report 10-782 at pp. 92-93.

13 In addition, Section 939F requires the Commission to address specific matters with respect to the Section 15E(w) System. See Pub. L. No. 111-203 § 939F. While these matters may be covered broadly by the GAO Framework, the Commission requests, in Section II.B, that interested parties address these matters through a series of additional targeted questions.

14 The classes of credit ratings for which an NRSRO can be registered are enumerated in the definition of "nationally recognized statistical rating organization" in Section 3(a)(62) of the Exchange Act: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) 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); and (5) issuers of government securities, municipal securities, or securities issued by a foreign government. 15 U.S.C. 78c(a)(62).

15 Item 7 of Form NRSRO requires an NRSRO to provide the approximate number of credit ratings outstanding in each class of credit rating for which the NRSRO is registered.

Figure 1




A. **The Credit Rating Process for Structured Finance Products and the Conflicts of Interest Associated with the Issuer-Pay And The Subscriber-Pay Models**

Section 939F(b)(1) provides that the Commission, in carrying out the study, shall address the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models.

Request for Comment

The Commission requests comments, proposals, data, and analysis to assist in analyzing the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models. In addition, the Commission request comments, proposals, data, and analysis in response to the following questions:

1. Describe the processes by which an NRSRO determines an initial credit rating for a structured finance product and, thereafter, monitors that credit rating.[16] If the processes

[16] In responding to the questions below about processes, interested parties are encouraged to use flow charts, if appropriate, to illustrate the processes described in responses, including using visual channels ("swim lanes") to identify NRSRO resources (e.g., entities, departments, personnel) involved or used in each step of the process and the

differ based on the type of structured finance product (e.g., a residential mortgage backed security ("RMBS"), a commercial mortgage-backed security ("CMBS"), a collateralized debt obligation ("CDO"), a collateralized loan obligation ("CLO"), an asset backed security collateralized by credit card receivables, auto loans, auto leases, dealer floor plan financing, student loans, consumer loans, consumer leases, equipment loans, equipment leases, or other similar financial assets ("other ABS"), an issuance by an asset-backed commercial paper conduit ("ABCP"), or any other structured finance product), describe the different processes and provide any supporting data and analysis. In describing the processes for these asset classes, interested parties are encouraged to describe any strengths or weaknesses of such processes. Responses should include:

a. A description of the process by which NRSROs are compensated for determining initial credit ratings for structured finance products and for ongoing monitoring of those ratings.

b. A description of the data collection phase of the process for determining and monitoring credit ratings for structured finance products, including: the types of data collected; the sources from which the data is obtained; whether, and, if so how, the data is validated; whether the data is public or non-public; and how, if at all, the data is captured in the NRSRO's systems.

c. A description of the analytical phase of the process for determining and monitoring credit ratings for structured finance products, including the types of analyses performed (e.g., cash flow, sensitivity, loss, and stress analysis).

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interactions between NRSRO personnel and internal and external parties during each step in the process.

d. A description of the process for approving and publishing a credit rating for a structured finance product, including the steps that could lead to the modification of the credit rating before it is published (e.g., an issuer "appeal" process).

e. A description of how the processes identified above and any other processes relating to determining and monitoring of structured finance products (including, absent or missing process steps or other process-related weaknesses) contributed, if at all, to the performance of credit ratings for structured finance products leading up and during the financial crisis. If process-related weaknesses contributed to the poor performance of credit ratings for structured finance products, describe whether and, if so, how those weaknesses have been addressed.

2. Provide data on the number of credit ratings for structured finance products initially determined by each NRSRO each year for the last ten years or identify sources of information where that data can be located. If possible, provide data for each asset class of structured finance products identified above.

3. Describe the potential conflicts of interest in the issuer-pay model in rating structured finance products. For example, in what ways, if any, does the issuer, underwriter, or sponsor ("arranger") of the structured finance product paying the NRSRO to determine the credit rating create conflicts of interest? What are the potential impacts on the NRSRO and the credit ratings issued from these conflicts of interest? Also, compare the potential conflicts in rating structured finance products with the potential conflicts in rating other classes of obligors, securities, or money market instruments, such as issuers that are financial institutions, non-financial corporations, insurance companies, and governments and municipalities. In this regard, does the concentration of underwriters

and sponsors of structured finance products potentially make any conflicts more acute in this class of credit ratings? Does having a large number of clients reduce risk that a single client could unduly influence the NRSRO? In addition, are the potential conflicts of interest more acute in terms of rating certain types of structured finance products as compared with other types of structured finance products? For example, do certain types of structured finance products account for a larger percentage of revenues to NRSROs than other types of products in today's market and the market as it existed prior to the credit crisis?

4. Is there empirical data, studies, or other information that the issuer-pay conflict of interest influenced credit ratings issued by NRSROs? If so, identify and describe any such data, studies, or other information. For example, is there empirical data, studies, or other information that initial credit ratings for structured finance products determined by NRSROs operating under the issuer-pay model are higher than initial credit ratings determined by NRSROs operating under the subscriber-pay model? If so, identify and describe any such data, studies, or other information. In addition, if it can be demonstrated that conflicts influenced the credit ratings for structured finance products, is there empirical data, studies, or other information that market participants understood the impact, by for example, pricing structured finance products differently than other types of securities or money market instruments with identical ratings? If so, identify and describe any such data, studies, or other information.

5. Describe any actions that NRSROs have taken or internal controls that NRSROs have in place, or could take or put in place, to mitigate conflicts of interests in the issuer-pay model.

6. Describe the potential conflicts of interest in the subscriber-pay model in rating structured finance products. Subscriber-paid credit ratings commonly are not made available for free (and, consequently, not broadly disseminated to the marketplace). What impact, if any, does this have on market participants' ability to detect conflicts of interest? In addition, address how the interests of subscribers may create potential incentives to unduly influence an NRSRO in determining a credit rating? For example, does a subscriber's investing limitations (e.g., a subscriber may only invest in structured finance products that are rated above a certain level in the rating scale of an NRSRO or may have a long or short position that could produce gains or losses depending on how a product is rated) create conflicts of interests? If so, in what manner and to what extent? Also, do subscriber-paid NRSROs have individual subscribers that account for a material portion of their annual revenues? For example, a subscriber could be a large financial institution that purchases multiple data feeds (subscriptions) to the NRSRO's credit ratings and analysis. If so, does this create a concentrated revenue source that may make the subscriber-paid conflict more acute, similar to the concentration of structured finance sponsors in the issuer-paid context? Also address whether the diversity of interest among the subscribers mitigates the possibility that a single subscriber can unduly influence ratings? For example, is this conflict mitigated to the extent that different subscribers may have different interests with respect to how a particular security is rated?
7. Is there empirical data, studies, or other information that the subscriber-pay conflict of interest influenced credit ratings issued by NRSROs? If so, identify and describe any such data, studies, or other information.

8. Describe any actions that NRSROs have taken or internal controls that NRSROs have in place, or could take or put in place, to mitigate the conflicts of interests in the subscriber-pay model.

9. Compare the types and degree of conflicts of interest presented by the issuer-pay and subscriber-pay models.

10. Does reputational risk mitigate potential conflicts of interest in the credit rating industry? If so, describe how? If not, describe why? In responding to these questions concerning reputational risk, identify and describe any supporting empirical data, studies, or other information.

11. NRSROs as such did not become subject to registration and oversight requirements until June 2007.[17] Given that much of the activity relating to the rating of RMBS and CDOs linked to subprime mortgages occurred prior to that date, describe if, and how the registration and oversight requirements have mitigated potential conflicts of interest in the rating of structured finance products? For example, Section 15E of the Exchange Act and the Commission's rules require NRSROs, among other things, to disclose and manage conflicts of interest and, in some cases, establish absolute prohibitions against having certain conflicts of interest.[18] In addition, the goal of the Credit Rating Agency Reform Act of 2006 – which established a registration and oversight program for NRSROs through self-executing provisions added to the Exchange Act and implementing rules adopted by the Commission under the Exchange Act as amended by the Rating

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17 See the Credit Rating Agency Reform Act of 2006 (Pub. L. No. 109-291 (2006)); see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007).

18 See, e.g., 15 U.S.C. 78o-7(h), 17 CFR 240.17g-5, and Exhibit 6 to Form NRSRO (17 CFR 249b.300).

Agency Act of 2006 – was to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry. Is there empirical data, studies, or other information that the measures in Section 15E of the Exchange Act and the Commission's rules have or have not mitigated conflicts of interest in rating structured finance products? If so, identify and describe any such data, studies, or other information.

12. Would government efforts to reduce investor reliance on credit ratings such as through provisions in Sections 939 and 939A of the Dodd-Frank Act mitigate the potential conflicts of interest in the rating of structured finance products? If so, how? Would the Section 15E(w) System have the potential to increase or mitigate the impact of other efforts to reduce investor reliance on credit ratings?

13. Describe the benefits of the current process for determining credit ratings for structured finance products. For example, what are the incentives under the current processes to produce accurate credit ratings? In addition, are there benefits in allowing the arranger to select the NRSRO to determine a credit rating for a structured finance product? For example, do arrangers select NRSROs based on their knowledge of which NRSROs investors will accept as issuing credible credit ratings? In addition, do arrangers select NRSROs based on their knowledge of which NRSROs have the resources, capacity, and technical competence to determine credit ratings for the structured finance product they are intending to bring to market, or, do arrangers select an NRSRO because they believe it will give them the highest rating?

14. The Section 15E(w) System would apply only to structured finance products. What are the differences, if any, between structured finance products and other products NRSROs

rate? Do these differences warrant a separate system for assigning credit ratings to NRSROs? If so, why?

**B. The Section 15E(w) System**

The Section 15E(w) System, among other things, would require the Commission to: (1) establish a Credit Rating Agency Board ("CRA Board"), which would be an SRO; (2) select the initial members of the CRA Board; and (3) establish a schedule to ensure that the CRA Board begins assigning qualified NRSROs ("Qualified NRSROs") to provide initial ratings not later than one year after the selection of the members of the CRA Board.[19] A Qualified NRSRO would be an NRSRO that the CRA Board determines to be qualified to issue initial credit ratings with respect to one or more categories of structured finance products.[20]

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19 See subparagraph (2)(A) of the Section 15E(w) Provisions. The CRA Board initially would be composed of an odd number of members selected from the industry, with the total numerical membership of the CRA Board to be determined by the Commission. See subparagraph (2)(C)(i) of the Section 15E(w) Provisions. Of the members initially selected to serve on the CRA Board: (1) not less than a majority of the members would need to be representatives of the investor industry who do not represent issuers; (2) not less than one member would need to be a representative of the issuer industry; (3) not less than one member would need to be a representative of the credit rating agency industry; and (4) not less than one member would need to be an independent member. See subparagraphs (2)(C)(ii)(I) through (IV) of the Section 15E(w) Provisions. The initial members of the CRA Board would be appointed to terms of 4 years. See subparagraph (2)(C)(i) of the Section 15E(w) Provisions. Prior to the expiration of the terms of office of the initial CRA Board members, the Commission would be required to establish fair procedures for the nomination and election of future members of the Board. See subparagraph (2)(C)(iv) of the Section 15E(w) Provisions.

20 See subparagraphs (1)(B) and (3) of the Section 15E(w) Provisions. An NRSRO seeking to become a Qualified NRSRO with respect to a category of structured finance products would need to submit an application to the CRA Board. See subparagraphs (3)(A) and (B) of the Section 15E(w) Provisions. The application would need to contain: (1) information about the institutional and technical capacity of the NRSRO to issue credit ratings; (2) information on whether the NRSRO has been exempted by the Commission from any requirements under Section 15E of the Exchange Act; and (3) any additional information the Board may require. See subparagraphs (3)(A)(ii)(I) through (III) of the Section 15E(w) Provisions.

An issuer that seeks an initial credit rating for a structured finance product would be prohibited from requesting such a rating from an NRSRO and, instead, be required to submit a request for the initial credit rating to the CRA Board.[21] The CRA Board would select a Qualified NRSRO to provide the initial credit rating to the issuer.[22] A Qualified NRSRO selected to determine an initial credit rating could refuse to accept a particular request by notifying the CRA Board of such refusal, and submitting to the CRA Board a written explanation of the refusal.[23] The CRA Board then would select a different Qualified NRSRO to determine the initial credit rating.[24] Qualified NRSROs would be able to determine fees unless the CRA Board determines it is necessary to issue rules on fees.[25] If rules are deemed necessary, a Qualified NRSRO would be required to charge an issuer a reasonable fee as determined by the Commission.[26]

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21 See subparagraph (4) of the Section 15E(w) Provisions. An issuer would be permitted to request or receive additional credit ratings for the structured finance product, if the initial credit rating is provided using the CRA Board assignment process. See subparagraph (9) of the Section 15E(w) Provisions.

22 See subparagraph (5)(A) of the Section 15E(w) Provisions. The method of selecting the Qualified NRSRO would be based on an evaluation by the CRA Board of a number of alternatives designed to reduce the conflicts of interest that exist under the issuer-pays model, including a lottery or rotating assignment system. See subparagraph (5)(B) of the Section 15E(w) Provisions. In addition, in evaluating the selection method, the CRA Board would be required to consider: (1) the information submitted by the Qualified NRSRO in its application to become a Qualified NRSRO regarding the institutional and technical capacity of the Qualified NRSRO to issue credit ratings; (2) an, at least, annual evaluation of the performance of each Qualified NRSRO; (3) formal feedback from institutional investors; and (4) information from items (1) and (2) to implement a mechanism which increases or decreases assignments based on past performance. See subparagraph (5)(B)(ii) of the Section 15E(w) Provisions. The CRA Board, in choosing a selection method, would not be able to use a method that allows for the solicitation or consideration of the preferred NRSRO of the issuer. See subparagraph (5)(B)(iii) of the Section 15E(w) Provisions.

23 See subparagraph (5)(C)(i) of the Section 15E(w) Provisions.

24 See subparagraph (5)(C)(ii) of the Section 15E(w) Provisions.

25 See subparagraph (8)(B) of the Section 15E(w) Provisions.

26 See subparagraph (8)(A) of the Section 15E(w) Provisions.

The CRA Board would be required to prescribe rules by which it evaluates the performance of each Qualified NRSRO, including rules that require, at a minimum, an annual evaluation of each Qualified NRSRO.[27] The CRA Board, in conducting the annual evaluation would be required to consider: (1) the results of an annual examination of the Qualified NRSRO; (2) surveillance of credit ratings conducted by the Qualified NRSRO after the credit ratings are issued, including, how the rated instruments perform, the accuracy of the ratings as compared to the other NRSROs, and the effectiveness of the methodologies used by the Qualified NRSRO; and (3) any additional factors the CRA Board determines to be relevant.[28]

Request for Comment

The Commission requests comments, proposals, data, or analysis that could assist in analyzing the Section 15E(w) System. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions and, to the extent that responses would differ based on whether the CRA Board is an SRO, a public utility, or private utility, please explain the differences.[29]

1. Identify and describe the benefits of implementing the Section 15E(w) System.

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27 See subparagraph (7)(A) of the Section 15E(w) Provisions.

28 See subparagraph (7)(B) of the Section 15E(w) Provisions. While the evaluation contemplates an annual examination of the Qualified NRSRO, the Section 15E(w) Provisions do not contain an explicit requirement for the CRA Board to conduct an annual examination of each Qualified NRSRO.

29 While the Section 15E(w) provisions would require the Commission to establish a CRA Board that is an SRO, Section 939F expands the possible types of entities that would assign credit ratings to include potentially a public or private utility. Consequently, for the purposes of evaluating the Section 15E(w) Provisions, the Commission requests that interested parties address how the nature of each of these alternative assigning entities (SRO, Public Utility, and Private Utility) might change analysis in the responses to the questions asked below. For the purposes of the questions, the Commission uses the term "CRA Board," however, interested parties should read that term to mean potentially an SRO, public utility, or private utility.

2. Identify and describe the costs of implementing the Section 15E(w) System.
3. Evaluate the Section 15E(w) System using the GAO Framework by addressing the following factors:[30]
   a. *Independence* – Address the ability of the Section 15E(w) System to mitigate conflicts of interest between the entity paying for the rating and the NRSRO.[31] To what extent, if any, would the Section 15E(w) System influence the relationship between the NRSRO and the entity paying for the rating? Would the Section 15E(w) System eliminate or mitigate conflict of interests between the entity paying for the rating and the NRSRO? If so, in what ways and to what extent? In addition, what potential conflicts would be created by such a system? What controls, if any would need to be implemented to mitigate these conflicts? In addition, how would the system limit conflicts of interest between users of ratings and the NRSRO, and between issuers and the NRSRO?
   b. *Accountability* – Address the ability of the Section 15E(w) System to promote NRSRO responsibility for the accuracy and timeliness of credit ratings.[32] Specifically:
      i. How would the system create or distort economic incentives for NRSROs to produce quality ratings over the life of a security?

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[30] The questions for each factor in the GAO Framework in most cases mirror questions contained in GAO Report 10-782. See GAO Report 10-782 at pp. 85-93. Commenters are encouraged to read the relevant sections of GAO Report 10-782 for more details on the reasoning behind these questions and the issues they seek to target and elicit comment on.

[31] See GAO Report 10-782 at p. 85 for a broader discussion of this factor in the GAO Framework.

[32] See GAO Report 10-782 at pp. 85-86 for a broader discussion of this factor in the GAO Framework.

ii. To what extent, if any, would the system create political or other influences that potentially could cause an NRSRO to consider factors other than the credit characteristics of the structured finance product when determining a credit rating for the product?

iii. How would NRSRO performance be evaluated and by whom under the system? For example, would the system rely on market forces or third parties to evaluate performance? Would the system rely on evaluations of performance by the CRA Board that assigns NRSROs to provide ratings? How would "quality" credit ratings be defined and what criteria would be used to assess ratings performance?

iv. When an NRSRO demonstrates poor performance, what would be the economic consequences under the system and who would determine those consequences? For example, how would an NRSRO's compensation or opportunity for future ratings business be linked to ratings performance?

c. *Competition* – Address the extent to which the Section 15E(w) System would create an environment in which NRSROs compete for customers by producing higher-quality ratings at competitive prices.[33] Specifically:

i. In which ways would the system encourage NRSROs to compete? To what extent would the system encourage competition around the quality of ratings, ratings fees, and product innovation? To what extent would NRSROs with higher-quality ratings be rewarded with additional ratings business? For example, once an NRSRO is deemed a qualified NRSRO would it be entitled

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[33] See GAO Report 10-782 at pp. 86-87 for a broader discussion of this factor in the GAO Framework.

to a pro rata share to all deals brought to the CRA Board based solely on its capacity? Alternatively, would the CRA Board assess the quality of the NRSRO and assign business based on qualitative metrics?

ii. To what extent would the system encourage new entrants and reduce barriers to entry in the industry? Alternatively, to what extent would the system discourage new entrants and increase barriers to entry?

iii. To what extent would the system allow for flexibility in the differing sizes, resources, and specialties of NRSROs?

iv. To what extent would market forces impact ratings fees under the system?

v. To what extent, if any, would the system incentivize NRSROs to compete other than on the basis of the accuracy and quality of their ratings?

d. *Transparency* – Address the accessibility, usability, and clarity of the Section 15E(w) System and the dissemination of information on the program to market participants.[34] Specifically, how clear would the mechanics of the system be to market participants? For example, describe the level of transparency that would exist under the system with respect to: (1) how the NRSRO would obtain ratings business; (2) how ratings fees would be determined; (3) how NRSROs would be compensated; and (4) how the program would link ratings performance to NRSRO compensation or the award of additional business.

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34 See GAO Report 10-782 at p. 88 for a broader discussion of this factor in the GAO Framework. The GAO notes that transparency in this context does not refer to the transparency or disclosure regime of the NRSROs but is specific to the transparency of the compensation model only. GAO Report 10-782 at p. 88, Footnote 112.

e. *Feasibility* – Address the simplicity and ease with which the Section 15E(w) System could be implemented in the securities market.[35] Specifically:

i. Would the system be easily implemented? If not, how difficult would implementing the system be?

ii. Could the system be instituted through existing regulatory or statutory authority or is additional authority needed?

iii. What would be the costs to implement the system and who would fund them?

iv. Which body would administer the system, and would this be an established body? If not, how would it be created?

v. What, if any, infrastructure would be needed to implement the system? What information technology would be required? Which body would be responsible for developing and maintaining it?

vi. What impact would the system have on bringing new issuances to market and trading on the secondary market?

vii. How many NRSROs would be required for the system to function as intended? How would the exit of an NRSRO from the ratings industry affect the system's feasibility? What impact would the system have on the financial viability of an NRSRO?

f. *Market acceptance and choice* – Address the willingness of the securities market to accept the Section 15E(w) System, the credit ratings produced under such a system,

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35 See GAO Report 10-782 at pp. 88-90 for a broader discussion of this factor in the GAO Framework.

and any new market players established by the system.[36] Specifically:

i. What role, if any, would market participants have in selecting NRSROs to produce credit ratings, assessing the quality of credit ratings, and determining NRSRO compensation? More specifically, what would the roles of issuers and investors be in these processes? Where would these roles differ between the Section 15E(w) System and other potential programs and what would be the trade-offs? Would all market participants be likely to accept the credit ratings produced under the Section 15E(w) System? If not, what would be the potential consequences for the securitization market?

ii. What impact, if any, would the system have on each market participant using the credit ratings?

iii. Would market participation need to be mandated, and if so, for which participants?

iv. To what extent, if any, might market participants discount the quality and reliability of a credit rating based on the system's approach to selecting which Qualified NRSRO would rate a structured finance product?

g. *Oversight*: Address how the Section 15E(w) System would be evaluated to help ensure that it works as intended.[37] Specifically:

i. Would the system provide for an independent internal control function?

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36 See GAO Report 10-782 at pp. 90-91 for a broader discussion of this factor in the GAO Framework.

37 See GAO Report 10-782 at pp. 92-93 for a broader discussion of this factor in the GAO Framework.

ii. What external oversight (from a regulator or third-party auditor) would the system provide to ensure it is working as intended? In what ways would the CRA Board be held accountable for its decisions?

iii. If third-party auditors would provide external oversight with respect to the system, how would they be selected, what would be their reporting responsibilities, and to whom would they report?

iv. Who would compensate the regulatory or third-party auditor for auditing the system? How would the compensation for the regulator/auditor be determined? How would it be funded?

v. To what extent would a third-party auditor allow flexibility in oversight to accommodate NRSROs of different sizes?

4. *Assessment of potential mechanisms for determining fees for NRSROs.* Section 939F(b)(2)(A) requires that the Commission's study address the feasibility of establishing a system in which a CRA Board assigns NRSROs to determine the credit ratings for structured finance products, including an assessment of the potential mechanisms for determining fees for NRSROs. Consequently, to the extent not addressed in responses to the questions above with respect to the GAO Framework, the Commission requests comment, proposals, data, and analysis on the following:

a. Under the Section 15E(w) System, the CRA Board would be required to assign which NRSRO (from a pool of Qualified NRSROs) is employed to determine the initial credit rating for a structured finance product. Consequently, would the fee a Qualified NRSRO could charge the arranger need to be set by rule? For example, each Qualified NRSRO would be assured of being assigned a percentage of the credit rating business brought to the CRA Board by issuers. Depending on capacity, certain NRSROs may be assigned to determine more credit ratings than other NRSROs. Therefore, in the absence of competitive market forces, would Qualified NRSROs charge unreasonably high fees? If so, what mechanism could be used to determine the reasonable fee? Should, for example, arrangers be able to reject a Qualified NRSRO that charges above market fees? Moreover, would the amount of the fee need to depend on the type of structured finance product being rated or the complexity of the structured finance product? For example, do NRSROs typically charge different fees depending on whether the structured finance product is, for example, an RMBS, a CMBS, a CDO, a CLO, other ABS, an issuance of ABCP, or another type of structured finance product? If so, would it be appropriate to set different fees on each type of structured finance product? In addition, how would fees be determined for new product types? Furthermore, do the fees charged by NRSROs depend on their business models? If so, how would this impact the determination of what constitutes a reasonable fee? In addition, would the amount of the fee need to depend on the complexity of a structured finance product, independently of its type? Finally, do the fees charged by NRSROs depend on the policies and procedures they use to determine credit ratings? If so, how would this impact the determination of what constitutes a reasonable fee?

b. In determining the reasonableness of fees, could the fees charged by NRSROs and other credit rating agencies to rate structured finance products outside the context of the assignment process serve as a benchmark? For example, under the Section 15E(w) System, the issuer, after obtaining an initial credit rating through the assignment process, would be able to obtain additional credit ratings not assigned by the CRA Board. Would the fee charged for these unassigned credit ratings for structured finance products provide a basis to set the fees used for assigned credit ratings? Alternatively, would the fees NRSROs charge to determine other classes of credit ratings such as for financial institutions, corporate issuers, insurance companies, and government issuers provide a basis to set the fees used for the assignment process? How do the fees charged to rate these types of obligors, securities, and money market instruments differ from the fees charged to rate structured finance products?

c. How could the fee setter determine and, thereafter, monitor whether the fee established by rule constitutes an "above market fee" that over-compensates the Qualified NRSRO (potentially imposing unfair costs on issuers that might be passed on to investors) or under-compensates the NRSRO (potentially causing it to devote less resources to determining the credit rating with possible consequences in terms of the quality of the credit rating)?

d. What would be the impact if the fee set by rule was viewed as too low by NRSROs? For example, would NRSROs refuse to apply to be Qualified NRSROs? Or, would too few NRSROs apply to be Qualified NRSROs to implement the program? How would the fee setter determine the appropriate level of fee to attract a sufficient number of NRSROs to the program without imposing greater costs on issuers than would be the case when fees are determined through a competitive process?

e. Could setting fees by rule have negative impacts on the quality of credit ratings? For example, could it reduce incentives for NRSROs to compete based on producing accurate credit ratings?

f. Are there instances where SROs, public utilities, or private utilities set fees between a company and an entity providing a service to the company that could serve as models for how to set reasonable fees for purposes of assigning credit ratings business? If so, describe how the mechanisms these entities use to set reasonable fees could apply in the assigned credit rating context.

g. Provide any other comments, proposals, data, or analysis that could assist in assessing potential mechanisms determining how to set reasonable fees for assigned structured finance credit ratings.

5. *Appropriate methods for paying fees to the NRSRO.* Section 939F(b)(2)(B) requires the Commission's study to address the feasibility of establishing a system in which a CRA Board assigns NRSROs to determine the credit ratings for structured finance products, including, an assessment of appropriate methods for paying fees to the NRSROs. Consequently, to the extent not addressed in responses to the questions above with respect to the GAO Framework, the Commission requests comment, proposals, data, and analysis on the following:

a. Under the 15E(w) System, how should a fee be provided to the Qualified NRSRO selected to determine an initial credit rating for an arranger? For example, should the arranger provide the fee to the CRA Board, which, in turn, would provide the funds to the NRSRO? Would it be appropriate for the CRA Board to receive and disburse funds in this manner? For example, the CRA Board acting as a conduit for the funds could create potential risk in terms of appropriately maintaining custody of the funds, accounting for the funds, and allocating the funds to the Qualified NRSROs. In addition, it would require the CRA Board to have sophisticated operational capabilities in terms of having access to systems to process financial transactions involving hundreds of thousands of dollars between potentially hundreds of arrangers of structured finance products and the Qualified NRSROs. For these reasons, having the CRA Board serve as temporary custodian of the funds paid by arrangers to Qualified NRSROs could substantially increase the costs of operating the CRA Board. Furthermore, if the CRA Board became insolvent, would the arranger or the Qualified NRSRO have a claim for the funds? Would this depend on how much work the NRSRO had performed in terms of determining the initial credit rating? In this regard, should the CRA Board provide the funds to the Qualified NRSRO when the Qualified NRSRO is selected to determine the credit rating or when the Qualified NRSRO issues the initial credit rating? What is the current practice in terms of the timing when arrangers pay NRSROs for determining initial credit ratings? In addition, how long is the period between the time an NRSRO is hired to determine an initial credit rating and the time the credit rating is issued? Does the length of time depend on the type of structured finance product being rated? If so, describe the different time periods.

b. Alternatively, should the arranger pay the fee directly to the selected Qualified NRSRO? If so, would this potentially negatively impact the goal of the Section 15E(w) System to address the conflict of interest arising from the issuer-pay model?

c. Should the CRA Board allocate the fee to determine the initial credit rating to the selected Qualified NRSRO over the term of the structured finance product? For example, should 50% of the fee be paid up-front and the balance of the fee be distributed periodically until all the principal and interest outstanding on the structured finance product is paid? Moreover, if the structured finance product goes into default, would it be appropriate to withhold the unpaid balance of the fee from the NRSRO? Would the appropriateness of withholding the fee depend on the initial rating? For example, if the initial rating is in one of the highest categories (e.g., AAA or AA) and the bond defaults, would it be more appropriate to withhold the fee from the NRSRO than if the initial rating were in a lower category (e.g., BB or CCC)? If it would be appropriate to withhold the unpaid balance of the fee in the case of default, what entity would be legally entitled to the unpaid balance of the fee? Would it be appropriate to return the unpaid balance to the issuer, underwriter, or sponsor of the structured finance product? Would it be appropriate to provide the unpaid balance to investors in the structured finance product? The Commission notes that the fees paid to rate structured finance products are a small fraction of the principal amount invested in an issuance of a structured finance product. Consequently, would a requirement to return the unpaid amount to investors create an expectation that the investors would be compensated for losses suffered if the structured finance product defaults? The Commission notes that a program of allocating the fee over the term of the structured finance product might require the CRA Board to serve as the conduit for the funds transferred from the arrangers to the Qualified NRSROs, raising the issues about custodial responsibility and attendant costs discussed above.

d. How should fees for performing surveillance of credit ratings be addressed under the Section 15E(w) System? For example, should the Qualified NRSRO selected to determine the initial credit rating be allowed to negotiate a surveillance fee directly with the arranger and receive such a fee directly from the arranger? Alternatively, should the fee to determine the initial credit rating include an amount to cover the cost of surveillance? If so, should the CRA Board disburse the surveillance fee to the Qualified NRSRO? If so, when should that distribution take place? In addition, if the Section 15E(w) System only applies to the fee for the initial credit rating, what issues would arise in terms of finding an NRSRO to provide surveillance? For example, if the selected Qualified NRSRO only agreed to provide the initial credit rating, what would happen if the arranger could not find an NRSRO to perform surveillance for a reasonable fee?

e. Provide any other comments, proposals, data, or analysis that could assist in assessing appropriate methods for paying fees to NRSROs.

6. *Extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government.* Section 939F(b)(2)(C) requires the Commission's study to address the feasibility of establishing a system in which a CRA Board assigns NRSROs to determine the credit ratings for structured finance products, including, an assessment of the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government. Consequently, to the extent not addressed in responses to the questions above with respect to the GAO Framework, the Commission requests comment, proposals, data, and analysis on the following:

a. Would investors and other users of credit ratings view credit ratings for structured finance products determined through the CRA Board assignment process as more reliable than other credit ratings and, consequently, perform less analysis themselves before investing in a structured finance product? For example, under the Section 15E(w) System, the CRA Board would determine whether an NRSRO is qualified to issue initial credit ratings with respect to one or more categories of structured finance products. In addition, the CRA Board would be required to conduct an annual evaluation of a Qualified NRSRO to consider, among other things, (1) the surveillance of credit ratings conducted by the Qualified NRSRO after the credit ratings are issued, including, how the rated instruments perform; (2) the accuracy of the ratings as compared to the other NRSROs; and (3) the effectiveness of the methodologies used by the Qualified NRSRO. Would investors view the CRA Board as providing a "stamp of approval" on, or an endorsement of, the credit ratings determined through the assignment process? If the Section 15E(w) System would increase investor reliance on credit ratings, what potential impact would such a consequence have on government efforts to reduce investor reliance on credit ratings such as through provisions in Sections 939 and 939A of the Dodd-Frank Act? For example, would the system cause investors and other users of credit ratings to increase their reliance credit ratings for structured finance products? If so, how much do investors and other users of credit ratings currently rely on credit ratings for structured finance products and how might that level of reliance change if the Section 15E(w) System was implemented?

b. Would the CRA Board, as a governmental or quasi-governmental entity, be susceptible to political pressure in terms of its assignment of credit ratings to Qualified NRSROs or its other responsibilities? In addition, would a Qualified NRSRO assigned to determine a credit rating be susceptible to political pressure to issue a credit rating at a level favored by the CRA Board in order to obtain additional assignments from the CRA Board?

c. Provide any other comments, proposals, data, or analysis that could assist in assessing the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government.

7. *Constitutional or other issues concerning the establishment of such a system.* Section 939F(b)(2)(D) requires the Commission's study to address the feasibility of establishing a system in which a CRA Board assigns NRSROs to determine the credit ratings for structured finance products, including, an assessment of any constitutional or other issues concerning the establishment of such a system. Consequently, to the extent not addressed in responses to the questions above with respect to the GAO Framework, the Commission requests comment, proposals, data, and analysis on the following:

a. In terms of operational feasibility, what is the likelihood that the number of NRSROs applying to be treated as Qualified NRSROs would be sufficient to achieve the goals of the Section 15E(w) System? For example, how many NRSROs would need to be determined to be Qualified NRSROs for the system to operate as envisioned? What would be the metric or process for measuring or determining the number of NRSROs necessary for the system to function? For example, how would the system match the number of structured finance product issuances with the necessary capacity, resources, and expertise to rate the products in a competent and timely manner? What would be the implications for the securitization markets if an insufficient number of NRSROs are determined to be Qualified NRSROs (either because not enough applied or because the applicants did not satisfy the criteria to be treated as Qualified NRSROs)?

b. In terms of operational feasibility, what level of staffing would be necessary for the CRA Board to carry out its responsibilities? In addition, what would be the necessary expertise and qualifications of the CRA Board members and staff to carry out the CRA Board's responsibilities? How could the CRA Board ensure that it has the necessary staffing and that its staff has the necessary expertise and qualifications?

c. In terms of operational feasibility, could the process by which the CRA Board selects a Qualified NRSRO materially delay the issuance of a structured finance product and diminish the quality of the credit ratings determined through the assignment process? For example, how would the CRA Board monitor which Qualified NRSROs have current capacity to undertake the determination of a credit rating sought by an arranger? If the CRA Board selects a Qualified NRSRO that refuses to rate the structured finance product because, for example, it has reached its capacity to determine initial credit ratings, how long would it take for the CRA Board to select another Qualified NRSRO? In addition, how would the CRA Board address situations where a Qualified NRSRO misjudges its ability to undertake the assignment to determine an initial credit rating? For example, the Qualified NRSRO, in order to increase revenues, might agree to more assignments than it is capable of handling or to an assignment to rate a type of structured finance product it does not have the technical expertise to rate. Could this circumstance potentially put the arranger in a situation where it must wait far longer to obtain a credit rating than would normally be the case because the Qualified NRSRO spends time attempting to determine the initial credit rating before ultimately refusing the assignment? Moreover, could the quality of the credit ratings determined through the assignment process be compromised because the Qualified NRSRO devotes fewer resources to rating structured finance products in order to accept more assignments or accepts an assignment to rate a type of structured finance product for which it lacks adequate technical expertise? If so, how could these issues be addressed?

d. In terms of operational feasibility, how would the CRA Board under the Section 15E(w) System perform the annual evaluation of each qualified NRSRO? Would an annual evaluation be sufficient to determine which Qualified NRSROs are selected on an on-going basis to determine initial credit ratings? For example, what if a Qualified NRSRO undergoes material changes between evaluations that would impact its ability to determine credit ratings? How would this be brought to the CRA Board's attention?

e. In terms of market effects, how would the Section 15E(w) System impact the securitization markets? For example, how would it impact the origination of residential mortgages, commercial mortgages, commercial loans, credit card receivables, auto loans, auto leases, dealer floor-plans, student loans, consumer loans, consumer leases, equipment loans, equipment leases, asset-backed commercial paper, or any other financial assets that are securitized? For example, would the uncertainty over which Qualified NRSRO would be selected to determine the initial credit rating or when the initial credit rating might be issued cause originators to finance the origination of these assets through means other than securitizing them? If so, what would be the implications for these markets? For example, would it cause originators to extend less credit? If so, how would this impact the economy? Alternatively, would the 15E(w) System give investors greater confidence in the integrity of credit ratings for structured finance products? Would that increased confidence facilitate the flow of credit?

f. In terms of legal feasibility, would the establishment of a CRA Board to assign credit ratings for structured finance products raise legal issues under the U.S. Constitution? Please provide legal analysis explaining any such issues.

g. In terms of legal feasibility, would the role of the Commission in overseeing the CRA Board raise legal issues? Please provide legal analysis explaining any such issues?

h. In terms of legal feasibility, do the securities laws provide the Commission with authority to implement the Section 15E(w) System? Interested parties who believe existing authority is sufficient to implement such a system should provide legal analysis supporting their conclusions, including identifying relevant statutory authority. Interested parties who believe existing authority is not sufficient to implement such a system should provide legal analysis supporting their conclusions. In addition, interested parties are encouraged to recommend statutory amendments that could provide the authority necessary for the Commission to implement such a system.

i. In terms of the potential to mitigate conflicts, would a Qualified NRSRO assigned to determine a credit rating for a structured finance product under the Section 15E(w)

System potentially have the incentive to provide a favorable credit rating to obtain future business from arrangers to determine credit ratings outside the process of the Section 15E(w) System? The Commission notes that under the Section 15E(w) System an arranger can obtain additional credit ratings from NRSROs after obtaining an initial credit rating through the CRA Board selection process. If this potential conflict would be in the Section 15E(w) System, how could it be addressed? Would the annual evaluations of the Qualified NRSROs by the CRA Board, as required under the Section 15E(w) Provisions, identify an NRSRO that was unduly influenced by this conflict?

j. In terms of the potential to mitigate conflicts, would an arranger be able to select more favorable credit ratings ("rating shop") notwithstanding the implementation of the Section 15E(w) System? If so, how?

k. In terms of the potential to mitigate conflicts, to what extent, if any, might market participants be able to create securities or money market instruments, or otherwise finance the assets underlying or linked to a structured finance product, so that the transaction does not fit within the definition of "structure finance product" and thereby avoid having to submit the deal to Section 15E(w) System? In addition, how would it be determined whether products fall within the definition of "structured finance product"?

l. Provide any other comments, proposals, data, or analysis that could assist in assessing Constitutional or other issues concerning the establishment of such a system.

8. *Range of metrics that could be used to determine the accuracy of credit ratings.* Section 939F(b)(3) requires that the Commission's study address the range of metrics that could

be used to determine the accuracy of credit ratings.[38] Consequently, to the extent not addressed in responses to the questions above with respect to the GAO Framework, the Commission requests comment, proposals, data, and analysis on the following:

a. How should the performance of credit ratings be measured in terms of accuracy?

b. Section 3(a)(60) of the Exchange Act defines the term "credit rating" to mean "an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments."[39] How should the term "accuracy" as applied to credit ratings be defined? For example, could there be a standard definition of "accuracy" that could be applied across all credit rating agencies that determine credit ratings for structured finance products? How feasible is such a definition given the differences in the procedures and methodologies NRSROs use to determine credit ratings and the ratings scales they use to denote relative creditworthiness? For example, some NRSROs may employ highly quantitative models under which the credit ratings are particularly sensitive to real-time information and, therefore, adjust frequently. Other NRSROs may employ qualitative approaches that result in credit ratings that remain more stable.

c. Could the definition of "accuracy" be based on whether the structured finance product goes into default? For example, defaults may be very rare for some classes of structured finance products. For these classes, how would a definition of "accuracy" based on default work?

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38 As noted above the CRA Board would be required to evaluate "the accuracy of the ratings provided by the qualified [NRSRO] as compared to other [NRSROs]." See subparagraph (7)(B)(ii)(II) of Section 15E(w) Provisions.

39 See 15 U.S.C. 78c(a)(60).

d. Depending on how an interested party defines "accuracy," what metrics could be used to measure accuracy? For example, could transition and default rates be used to measure accuracy? With respect to transition and default rates, how would their effectiveness in measuring the "accuracy" of the credit ratings be impacted by favorable or benign economic conditions? For example, in favorable economic conditions the ratings for structured finance products may remain stable and the number of defaults may be statistically insignificant.

e. Over what time horizons should the accuracy of credit ratings be measured? For example, should it be measured over a period of years, or the life of the securities? Should ratings be evaluated for accuracy at specific points in time? If accuracy should be evaluated at specific points in time, should those times relate to events experienced by the security, or be unrelated to the security (e.g., calendar-related only)? Could using a specific time horizon distort how Qualified NRSROs determine credit ratings? For example, if the time horizon is longer, could Qualified NRSROs determine credit ratings at lower levels in the their rating scales in order to lessen the chance that the credit rating would be downgraded during the period? Alternatively, if the time horizon is short, could Qualified NRSROs be more prone to determine credit ratings at higher levels in their rating scales?

f. Could the method of measuring accuracy create disincentives for Qualified NRSROs to determine credit ratings for certain types of products? For example, could Qualified NRSROs refuse to rate structured finance products that are inherently more volatile in terms of potential credit risk? If so, how could this impact capital formation?

g. Provide any other comments, proposals, data, or analysis that could assist in assessing the range of metrics that could be used to determine the accuracy of credit ratings.

### C. Alternative means for compensating NRSROs that would create incentives for accurate credit ratings

Section 939F(b)(4) requires the Commission's study to address alternative means for compensating NRSROs that would create incentives for accurate credit ratings. Consequently, the Commission requests interested parties to provide comments, proposals, data, and analysis on any potential alternatives to the Section 15E(w) System. In this regard, several models that would establish alternative means for compensating NRSROs are identified below.[40] The Commission requests comment on these models. In addition, the Commission requests comment on models not identified below that an interested party believes would achieve the objective of creating incentives for accurate credit ratings. Any such model should be described and analyzed using the GAO Framework.

#### 1. The Rule 17g-5 Program

The Commission has adopted requirements codified in Rule 17g-5 designed to create a mechanism for an NRSRO that is not hired to determine a credit rating for a structured finance product to nonetheless obtain the same information the hired NRSRO receives from the arranger to determine the initial credit rating and at the same time such information is provided to the

40 Aside from the Rule 17g-5 Program, the alternatives identified below are drawn from GAO Report 10-782 at pp. 79-84. The first alternative in the GAO Report (the "Random Selection Model") is not identified below because it is similar to the Section 15E(w) System. Commenters are encouraged to read the relevant sections of GAO Report 10-782 for more details about these proposed alternative payment models and their goals and objectives.

hired NRSRO (the "Rule 17g-5 Program").[41] The goal is to create a means for an NRSRO not hired to rate the structured finance product to nonetheless determine an initial credit rating at the same time the hired NRSRO determines an initial credit rating and conduct surveillance on that credit rating along with the hired NRSRO.[42] In other words, similar to the goal of Section 939F, the Rule 17g-5 Program is intended to prevent the arranger of the structured finance product from selecting the NRSRO or NRSROs that exclusively can determine the initial credit rating for the structured finance product.[43] When adopting the Rule 17g-5 Program, the Commission stated that it was designed to make it more difficult for arrangers to exert influence over the NRSROs they hire because any inappropriate rating could be exposed to the market through the

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41 17 CFR 240.17g-5(a)(3) and (b)(9). The Commission notes that it granted a conditional exemption to NRSROs from Rule 17g-5(a)(3) with respect to credit ratings where: (1) the issuer of the structured finance product is a non-U.S. person; and (2) the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions in the structured finance product after issuance, only in transactions that occur outside the U.S. These conditions are designed to confine the exemption's application to credit ratings of structured finance products issued in, and linked to, financial markets outside the U.S. See Exchange Act Release 62120 (May 19, 2010) 75 FR 28825 (May 24, 2010); see also Exchange Act Release 63363 (Nov. 23, 2010) 75 FR 73137 (Nov. 29, 2010).

42 The Commission noted when adopting the Rule 17g-5 Program that "when an NRSRO is hired to rate a structured finance product, some of the information it relies on to determine the rating is generally not made public. As a result, structured finance products frequently are issued with ratings from only one or two NRSROs that have been hired by the arranger, with the attendant conflict of interest. The [Rule 17g-5 Program is] designed to increase the number of credit ratings extant for a given structured finance product and, in particular, to promote the issuance of credit ratings by NRSROs that are not hired by the arranger." See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63844 (Dec. 4, 2009).

43 See Pub. L. No. 111-203 § 939F(d) ("After submission of the report under subsection (c), the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system for the assignment of [NRSROs] to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the [NRSRO] that will determine the initial credit ratings and monitor such credit ratings.").

unsolicited ratings issued by NRSROs not hired to rate the structured finance product.[44] The Commission also notes that investors seeking a credit rating from an NRSRO not hired to rate the structured finance product can pay an NRSRO of their choosing to rate the structured finance product using the Rule 17g-5 Program. Thus, it provides a mechanism for investors to select an NRSRO to rate a structured finance product they are considering purchasing or have purchased.

The Rule 17g-5 Program operates by requiring an NRSRO hired to determine initial credit ratings for structured finance products to maintain a password-protected Internet website containing a list of each such structured finance product for which it currently is in the process of determining an initial credit rating.[45] The list must be in chronological order and identify the type of security or money market instrument, the name of the issuer of the structured finance product, the date the rating process was initiated, and the Internet website address where the arranger of the structured finance product represents that information provided to the hired NRSRO can be accessed by other NRSROs.[46] The hired NRSRO must provide free and unlimited access to the website to any other NRSRO that provides it with a copy of a certification stating, among other things, that it is accessing the website solely for the purpose of determining or monitoring credit ratings.[47]

In addition, the hired NRSRO must obtain a written representation from the arranger of the structured finance product that the NRSRO can reasonably rely on.[48] The arranger must

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44 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63844 (Dec. 4, 2009).

45 See 17 CFR 240.17g-5(a)(3)(i).

46 Id.

47 See 17 CFR 240.17g-5(a)(3)(ii).

48 See 17 CFR 240.17g-5(a)(3)(iii). When adopting the Rule 17g-5 Program, the Commission stated that the "question of whether reliance was reasonable will depend on the facts and circumstances of a given situation. Factors relevant to this analysis would

represent, among other things, that it will maintain a password-protected Internet website that other NRSROs can access.[49] Further, the arranger must represent that it will post on this website all information the arranger provides to the hired NRSRO, or contracts with a third party to provide to the hired NRSRO, for the purpose of determining the initial credit rating and undertaking credit rating surveillance.[50] The arranger also must represent that this information will be posted to the Internet website at the same time such information is provided to the hired NRSRO.[51]

The Commission notes that the Rule 17g-5 Program is but one aspect of the current registration and oversight program for NRSROs designed to address conflicts of interest, including provisions designed to promote transparency and competition. Among other things, NRSROs currently are required to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest that can arise from their business.[52] In addition, NRSROs are required to disclose the types of potential conflicts of interest relating to the issuance of credit ratings and the policies and procedures they have established to address those conflicts of interest.[53] Moreover, NRSROs are prohibited from having conflicts of interest unless they have disclosed them and established policies and procedures reasonably designed to address them and, with respect to some conflicts, are

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include, but not be limited to: (1) ongoing or prior failures by the arranger to adhere to the representations; or (2) a pattern of conduct by the arranger where it fails to promptly correct breaches of its representations." See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63847 (December 4, 2009).

49 See 17 CFR 240.17g-5(a)(3)(iii).

50 Id.

51 Id.

52 See 15 U.S.C. 78o-7(h)(1).

53 See Exhibits 6 and 7 to Form NRSRO and the Instructions for those Exhibits.

prohibited from having the conflict in all circumstances.[54] Furthermore, NRSROs are required to disclose information about the performance of their credit ratings and about their procedures and methodologies for determining credit ratings.[55] These requirements are designed to mitigate potential conflicts of interest, and allow market participants to assess the quality of an NRSRO's ratings process and the ability of the NRSRO to address potential conflicts. The goal is to improve ratings quality by fostering accountability, transparency, and competition.

Request for Comment

The Commission requests interested parties to provide comments, proposals, data, and analysis on whether the Rule 17g-5 Program provides a reasonable alternative to the Section 15E(w) System in terms of objectives and goals. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions:

1. Interested parties are asked to provide a comparative evaluation of the Section 15E(w) System with the Rule 17g-5 Program using the GAO Framework.
2. If an interested party believes the Rule 17g-5 Program would not be a reasonable alternative to the Section 15E(w) System in terms of objectives and goals, could the Rule 17g-5 Program be modified to bridge the gap? If so, describe how? In addition, identify any additional benefits and costs that would result from such modifications.
3. To the extent not addressed in responding to the questions above, describe how the Rule 17g-5 Program currently is being used to determine credit ratings for structured finance products. For example, is there sufficient time between when information about a pending transaction is posted on the arranger's Internet website and the transaction closes for an NRSRO not hired to rate the structured finance product to determine an initial

54 See 17 CFR 240.17g-5.

55 See Exhibits 1 and 2 to Form NRSRO and the Instructions for those Exhibits.

credit rating? If not, how could this issue be addressed to provide a sufficient amount of time? For example, should there be a mandatory time period before a credit rating can be issued by the hired NRSRO? In addition, are NRSROs seeking to determine unsolicited credit ratings using the Rule 17g-5 Program being asked to agree to terms and conditions that are not required of the hired NRSROs? If so, what is the rationale for requiring such different terms and conditions?

### 2. Investor-Owned Credit Rating Agency Model

Under the Investor-Owned Credit Rating Agency Model, sophisticated investors would establish and operate an NRSRO that would produce credit ratings for structured finance products.[56] Issuers would be required to obtain two ratings: one from the investor-owned credit rating agency and the second from their choice of NRSRO.

Request for Comment

The Commission requests interested parties to provide comments, proposals, data, and analysis on whether the Investor-Owned Credit Rating Agency Model provides a reasonable alternative to the Section 15E(w) System in terms of objectives and goals. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions:

1. Interested parties are asked to provide a comparative evaluation of the Section 15E(w) System with the Investor-Owned Credit Rating Agency Model using the GAO Framework.
2. If an interested party believes the Investor-Owned Credit Rating Agency Model would be a reasonable alternative to the Section 15E(w) System in terms of objectives and goals,

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[56] See GAO-Report 10-782 at p. 82 for a more detailed description of this model.

explain how such a program could be implemented by the Commission. Could investors be required to participate? Should they be required to participate? In addition, analyze whether the Commission could implement such a program using existing authority in the securities laws or whether statutory amendments would be necessary. Finally, identify the benefits and costs of implementing such a program.

### 3. Stand-Alone Model

Under the Stand-Alone Model, an NRSRO would be compensated through transaction fees imposed on original issuance and on secondary market transactions.[57] Part of the fee would be paid by the issuer or secondary-market seller and the other portion of the fee by the investors purchasing the security in either the primary or secondary markets. Further, the NRSRO would be compensated over the life of the security based on these transaction fees.

Request for Comment

The Commission requests interested parties to provide comments, proposals, data, and analysis on whether the Stand-Alone Model provides a reasonable alternative to the Section 15E(w) System in terms of objectives and goals. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions:

1. Interested parties are asked to provide a comparative evaluation of the Section 15E(w) System with the Stand-Alone Model using the GAO Framework.
2. If an interested party believes the Stand-Alone Model would be a reasonable alternative to the Section 15E(w) System in terms of objectives and goals, explain how such a program could be implemented by the Commission. In addition, analyze whether the Commission could implement such a program using existing authority in the securities

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57 See GAO-Report 10-782 at pp. 82-83 for a more detailed description of this model.

laws or whether statutory amendments would be necessary. Finally, identify the benefits and costs of implementing such a program.

### 4. Designation Model

Under the designation model, all NRSROs would have the option of rating a new structured finance product issuance, and security holders would direct, or designate, fees to the NRSROs of their choice, based on the proportion of securities that they owned.[58] The issuer would be required to provide all interested NRSROs with the information to rate the structured finance product and pay the rating fees to a third-party administrator, which would manage the designation process. When the structured finance product was issued, the security holders would designate which of the NRSROs that rated the structured finance product should receive fees, based on their perception of research underlying the ratings. The security holders could designate one or several NRSROs. After the initial credit rating, the issuer would continue to pay maintenance rating fees to the third-party administrator, which bond holders also would allocate through the designation process every quarter over the life of the security. Additionally, under the Designation Model investors would review the quality of the work of the NRSROs and designate which firms should be compensated based on that review.[59]

Request for Comment

The Commission requests interested parties to provide comments, proposals, data, and analysis on whether the Designation Model provides a reasonable alternative to the Section

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58 See GAO-Report 10-782 at pp. 83-84 for a more detailed description of this model.

59 Id; see also Clark, Mayree and Andrew Jones "A Free Approach to Rating Agency Function," *SEC Roundtable to Examine Oversight of Credit Rating Agencies* (April 15, 2009). A variation of the Designation Model would include imposing a moratorium between the issuance of a security and the publication of a rating by an NRSRO; see "Wait to Rate: How to Save the Rating Agencies (and the Capital Markets)" presentation by Pershing Square Capital Management, L.P. (May 26, 2010).

15E(w) System in terms of objectives and goals. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions:

1. Interested parties are asked to provide a comparative evaluation of the Section 15E(w) System with the Designation Model using the GAO Framework.
2. If an interested party believes the Designation Model would be a reasonable alternative to the Section 15E(w) System in terms of objectives and goals, explain how such a program could be implemented by the Commission. In addition, analyze whether the Commission could implement such a program using existing authority in the securities laws or whether statutory amendments would be necessary. Finally, identify the benefits and costs of implementing such a program.

**5. User-Pay Model**

Under the User-Pay Model, issuers would not pay for credit ratings of structured finance products.[60] Instead, all "users" of structured finance credit ratings would be required to enter into a contract with the NRSRO and pay for the rating service of an NRSRO. Users would be defined as "any entity that included a rated security, loan, or contract as an element of its assets or liabilities as recorded in an audited financial statement."[61] Users would also include holders of long or short positions in fixed-income instruments, as well as parties that refer to a credit rating in contractual commitments or that are parties to derivative products that rely on rated securities or entities.[62] The model would rely on third-party auditors to ensure that NRSROs receive payment from users of credit ratings.

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60 See GAO-Report 10-782 at p. 84 for a more detailed description of this model.

61 Id.

62 Id.

Request for Comment

The Commission requests interested parties to provide comments, proposals, data, and analysis on whether the User-Pay Model provides a reasonable alternative to the Section 15E(w) System in terms of objectives and goals. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions:

1. Interested parties are asked to provide a comparative evaluation of the Section 15E(w) System with the User-Pay Model using the GAO Framework.
2. If an interested party believes the User-Pay Model would be a reasonable alternative to the Section 15E(w) System in terms of objectives and goals, explain how such a program could be implemented by the Commission. In addition, analyze whether the Commission could implement such a program using existing authority in the securities laws or whether statutory amendments would be necessary. Finally, identify the benefits and costs of implementing such a program.

### 6. Other Alternative Models

Interested parties are encouraged to identify any other model that could serve as a reasonable alternative to the Section 15E(w) System in terms of objectives and goals.

Request for Comment

The Commission requests interested parties to provide comments, proposals, data, and analysis on any other model that they believe would provide a reasonable alternative to the Section 15E(w) System in terms of objectives and goals. In addition, the Commission requests comments, proposals, data, and analysis in response to the following questions:

1. Interested parties are asked to provide a comparative evaluation of the Section 15E(w) System with the other model.

2. If an interested party believes the other model would be a reasonable alternative to the Section 15E(w) System in terms of objectives and goals, explain how such a program could be implemented by the Commission. In addition, analyze whether the Commission could implement such a program using existing authority in the securities laws or whether statutory amendments would be necessary. Finally, identify the benefits and costs of implementing such a program.

## III. CONCLUSION

All interested parties are invited to submit their views, in writing, on these questions.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

**Dated: May 10, 2011**

## APPENDIX:

## TEXT OF SECTION 15E(w) PROVISIONS[63]

63 Section 15(w) of the Securities Exchange Act of 1934, as that provision would have been added by Section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010.

***SEC. 939D. INITIAL CREDIT RATING ASSIGNMENTS.***

*Section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7), as amended by this Act, is amended by adding at the end the following:*

*"(w) INITIAL CREDIT RATING ASSIGNMENTS.—*

*"(1) DEFINITIONS.—In this subsection the following definitions shall apply:*

*"(A) BOARD.—The term 'Board' means the Credit Rating Agency Board established under paragraph (2).*

*"(B) QUALIFIED NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—The term 'qualified nationally recognized statistical rating organization', with respect to a category of structured finance products, means a nationally recognized statistical rating organization that the Board determines, under paragraph (3)(B), to be qualified to issue initial credit ratings with respect to such category.*

*"(C) REGULATIONS.—*

*"(i) CATEGORY OF STRUCTURED FINANCE PRODUCTS.—*

*"(I) IN GENERAL.—The term 'category of structured finance products'—*

*"(aa) shall include any asset backed security and any structured product based on an asset-backed security; and*

*"(bb) shall be further defined and expanded by the Commission, by rule, as necessary.*

"(II) CONSIDERATIONS.—In issuing the regulations required under subclause (I), the Commission shall consider—

"(aa) the types of issuers that issue structured finance products;

"(bb) the types of investors who purchase structured finance products;

"(cc) the different categories of structured finance products according to—

"(AA) the types of capital flow and legal structure used;

"(BB) the types of underlying products used; and

"(CC) the types of terms used in debt securities;

"(dd) the different values of debt securities; and

"(ee) the different numbers of units of debt securities that are issued together.

"(ii) REASONABLE FEE.—The Board shall issue regulations to define the term 'reasonable fee'.

"(2) CREDIT RATING AGENCY BOARD.—

"(A) IN GENERAL.—Not later than 180 days after the date of enactment of the Restoring American Financial Stability Act of 2010, the Commission shall—

"(i) establish the Credit Rating Agency Board, which shall be a self-regulatory organization;

"(ii) subject to subparagraph (C), select the initial members of the Board; and

"(iii) establish a schedule to ensure that the Board begins assigning qualified nationally recognized statistical rating organizations to provide initial ratings not later than 1 year after the selection of the members of the Board.

"(B) SCHEDULE.—The schedule established under subparagraph (A)(iii) shall prescribe when—

"(i) the Board will conduct a study of the securitization and ratings process and *provide recommendations to the Commission;*

*"(ii) the Commission will issue rules and regulations under this section;*

*"(iii) the Board may issue rules under this subsection; and*

*"(iv) the Board will—*

*"(I) begin accepting applications to select qualified national recognized statistical rating organizations; and*

*"(II) begin assigning qualified national recognized statistical rating organizations to provide initial ratings.*

*"(C) MEMBERSHIP.—*

*"(i) IN GENERAL.—The Board shall initially be composed of an odd number of members selected from the industry, with the total numerical membership of the Board to be determined by the Commission.*

*"(ii) SPECIFICATIONS.—Of the members initially selected to serve on the Board—*

*"(I) not less than a majority of the members shall be representatives of*

*the investor industry who do not represent issuers;*

*"(II) not less than 1 member should be a representative of the issuer industry;*

*"(III) not less than 1 member should be a representative of the credit rating agency industry; and*

*"(IV) not less than 1 member should be an independent member.*

*"(iii) TERMS.—Initial members shall be appointed by the Commission for a term of 4 years.*

*"(iv) NOMINATION AND ELECTION OF MEMBERS.—*

*"(I) IN GENERAL.—Prior to the expiration of the terms of office of the initial members, the Commission shall establish fair procedures for the nomination and election of future members of the Board.*

*"(II) MODIFICATIONS OF THE BOARD.—Prior to the expiration of the terms of office of the initial members, the Commission—*

*"(aa) may increase the size of the board to a larger odd number and adjust the length of future terms; and*

*"(bb) shall retain the composition of members described in clause (ii).*

*"(v) RESPONSIBILITIES OF MEMBERS.—Members shall perform, at a minimum, the duties described in this subsection.*

*"(vi) RULEMAKING AUTHORITY.—The Commission shall, if it determines necessary and appropriate, issue further rules and regulations on the composition of the membership of the Board and the responsibilities of the members.*

*"(D) OTHER AUTHORITIES OF THE BOARD.—The Board shall have the authority to levy fees from qualified nationally recognized statistical rating organization applicants, and periodically from qualified nationally recognized statistical rating organizations as necessary to fund expenses of the Board.*

"(E) REGULATION.—The Commission has the authority to regulate the activities of the Board, and issue any further regulations of the Board it deems necessary, not in contravention with the intent of this section.

"(3) BOARD SELECTION OF QUALIFIED NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—

"(A) APPLICATION.—

"(i) IN GENERAL.—A nationally recognized statistical rating organization may submit an application to the Board, in such form and manner as the Board may require, to become a qualified nationally recognized statistical rating organization with respect to a category of structured finance products.

"(ii) CONTENTS.—An application submitted under clause (i) shall contain—

"(I) information regarding the institutional and technical capacity of the nationally recognized statistical rating organization to issue credit ratings;

*"(II) information on whether the nationally recognized statistical rating organization has been exempted by the Commission from any requirements under any other provision of this section; and*

*"(III) any additional information the Board may require.*

*"(iii) REJECTION OF APPLICATIONS.—The Board may reject an application submitted under this paragraph if the nationally recognized statistical rating organization has been exempted by the Commission from any requirements under any other provision of this section.*

*"(B) SELECTION.—The Board shall select qualified national recognized statistical rating organizations with respect to each category of structured finance products from among nationally recognized statistical rating organizations that submit applications under subparagraph (A).*

*"(C) RETENTION OF STATUS AND OBLIGATIONS AFTER SELECTION.—An entity selected as a qualified nationally recognized statistical rat-*

*ing organization shall retain its status and obligations under the law as a nationally recognized statistical rating organization, and nothing in this subsection grants authority to the Commission or the Board to exempt qualified nationally recognized statistical rating organizations from obligations or requirements otherwise imposed by Federal law on nationally recognized statistical rating organizations.*

*"(4) REQUESTING AN INITIAL CREDIT RATING.—An issuer that seeks an initial credit rating for a structured finance product—*

*"(A) may not request an initial credit rating from a nationally recognized statistical rating organization; and*

*"(B) shall submit a request for an initial credit rating to the Board, in such form and manner as the Board may prescribe.*

*"(5) ASSIGNMENT OF RATING DUTIES.—*

*"(A) IN GENERAL.—For each request received by the Board under paragraph (4)(B), the Board shall select a qualified nationally recognized statistical rating organization to provide the initial credit rating to the issuer.*

*"(B) METHOD OF SELECTION.—*

*"(i) IN GENERAL.—The Board shall—*

*"(I) evaluate a number of selection methods, including a lottery or rotating assignment system, incorporating the factors described in clause (ii), to reduce the conflicts of interest that exist under the issuer-pays model; and*

*"(II) prescribe and publish the selection method to be used under subparagraph (A).*

*"(ii) CONSIDERATION.—In evaluating a selection method described in clause (i)(I), the Board shall consider—*

*"(I) the information submitted by the qualified nationally recognized statistical rating organization under paragraph (3)(A)(ii) regarding the institutional and technical capacity of the qualified nationally recognized statistical rating organization to issue credit ratings;*

*"(II) evaluations conducted under paragraph (7);*

*"(III) formal feedback from institutional investors; and*

*"(IV) information from subclauses (I) and (II) to implement a mechanism which increases or decreases assignments based on past performance.*

*"(iii) PROHIBITION.—The Board, in choosing a selection method, may not use a method that would allow for the solicitation or consideration of the preferred national recognized statistical rating organizations of the issuer.*

*"(iv) ADJUSTMENT OF PROCESS.—The Board shall issue rules describing the process by which it can modify the assignment process described in clause (i).*

*"(C) RIGHT OF REFUSAL.—*

*"(i) REFUSAL.—A qualified nationally recognized statistical rating organization selected under subparagraph (A) may refuse to accept a selection for a particular request by—*

*"(I) notifying the Board of such refusal; and*

*"(II) submitting to the Board a written explanation of the refusal.*

*"(ii) SELECTION.—Upon receipt of a notification under clause (i), the Board shall make an additional selection under subparagraph (A).*

*"(iii) INSPECTION REPORTS.—The Board shall annually submit any explanations of refusals received under clause (i)(II) to the Commission, and such explanatory submissions shall be published in the annual inspection reports required under subsection (p)(3)(C).*

*"(6) DISCLAIMER REQUIRED.—Each initial credit rating issued under this subsection shall include, in writing, the following disclaimer: 'This initial rating has not been evaluated, approved, or certified by the Government of the United States or by a Federal agency.'.*

*"(7) EVALUATION OF PERFORMANCE.—*

*"(A) IN GENERAL.—The Board shall prescribe rules by which the Board will evaluate the performance of each qualified nationally recognized statistical rating organization, including rules that require, at a minimum, an annual*

*evaluation of each qualified nationally recognized statistical rating organization.*

*"(B) CONSIDERATIONS.—The Board, in conducting an evaluation under subparagraph (A), shall consider—*

*"(i) the results of the annual examination conducted under subsection (p)(3);*

*"(ii) surveillance of credit ratings conducted by the qualified nationally recognized statistical rating organization after the credit ratings are issued, including—*

*"(I) how the rated instruments perform;*

*"(II) the accuracy of the ratings provided by the qualified nationally recognized statistical rating organization as compared to the other nationally recognized statistical rating organizations; and*

*"(III) the effectiveness of the methodologies used by the qualified nationally recognized statistical rating organization; and*

*"(iii) any additional factors the Board determines to be relevant.*

"(C) REQUEST FOR REEVALUATION.—*Subject to rules prescribed by the Board, and not less frequently than once a year, a qualified nationally recognized statistical rating organization may request that the Board conduct an evaluation under this paragraph.*

"(D) DISCLOSURE.—*The Board shall make the evaluations conducted under this paragraph available to Congress.*

"(8) RATING FEES CHARGED TO ISSUERS.—

"(A) LIMITED TO REASONABLE FEES.—*A qualified nationally recognized statistical rating organization shall charge an issuer a reasonable fee, as determined by the Commission, for an initial credit rating provided under this section.*

"(B) FEES.—*Fees may be determined by the qualified national recognized statistical rating organizations unless the Board determines it is necessary to issue rules on fees.*

"(9) NO PROHIBITION ON ADDITIONAL RATINGS.—*Nothing in this section shall prohibit an issuer from requesting or receiving additional credit ratings with respect to a debt security, if the initial credit rating is provided in accordance with this section.*

*"(10) NO PROHIBITION ON INDEPENDENT RATINGS OFFERED BY NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.—*

*"(A) IN GENERAL.—Nothing in this section shall prohibit a nationally recognized statistical rating organization from independently providing a credit rating with respect to a debt security, if—*

*"(i) the nationally recognized statistical rating organization does not enter into a contract with the issuer of the debt security to provide the initial credit rating; and*

*"(ii) the nationally recognized statistical rating organization is not paid by the issuer of the debt security to provide the initial credit rating.*

*"(B) RULE OF CONSTRUCTION.—For purposes of this section, a credit rating described in subparagraph (A) may not be construed to be an initial credit rating.*

*"(11) PUBLIC COMMUNICATIONS.—Any communications made with the public by an issuer with respect to the credit rating of a debt security shall clearly specify whether the credit rating was made by—*

*"(A) a qualified nationally recognized statistical rating organization selected under paragraph (5)(A) to provide the initial credit rating for such debt security; or*

*"(B) a nationally recognized statistical rating organization not selected under paragraph (5)(A).*

*"(12) PROHIBITION ON MISREPRESENTATION.—With respect to a debt security, it shall be unlawful for any person to misrepresent any subsequent credit rating provided for such debt security as an initial credit rating provided for such debt security by a qualified nationally recognized statistical rating organization selected under paragraph (5)(A).*

*"(13) INITIAL CREDIT RATING REVISION AFTER MATERIAL CHANGE IN CIRCUMSTANCE.—If the Board determines that it is necessary or appropriate in the public interest or for the protection of investors, the Board may issue regulations requiring that an issuer that has received an initial credit rating under this subsection request a revised initial credit rating, using the same method as provided under paragraph (4), each time the issuer experiences a material change in circumstances, as defined by the Board.*

*"(14) CONFLICTS.—*

"(A) *MEMBERS OR EMPLOYEES OF THE BOARD.*—

"(i) *LOAN OF MONEY OR SECURITIES PROHIBITED.*—

"(I) *IN GENERAL.*—*A member or employee of the Board shall not accept any loan of money or securities, or anything above nominal value, from any nationally recognized statistical rating organization, issuer, or investor.*

"(II) *EXCEPTION.*—*The prohibition in subclause (I) does not apply to a loan made in the context of disclosed, routine banking and brokerage agreements, or a loan that is clearly motivated by a personal or family relationship.*

"(ii) *EMPLOYMENT NEGOTIATIONS PROHIBITION.*—*A member or employee of the Board shall not engage in employment negotiations with any nationally recognized statistical rating organization, issuer, or investor, unless the member or employee*—

"(I) discloses the negotiations immediately upon initiation of the negotiations; and

"(II) recuses himself from all proceedings concerning the entity involved in the negotiations until termination of negotiations or until termination of his employment by the Board, if an offer of employment is accepted.

"(B) CREDIT ANALYSTS.—

"(i) IN GENERAL.—A credit analyst of a qualified nationally recognized statistical rating organization shall not accept any loan of money or securities, or anything above nominal value, from any issuer or investor.

"(ii) EXCEPTION.—The prohibition described in clause (i) does not apply to a loan made in the context of disclosed, routine banking and brokerage agreements, or a loan that is clearly motivated by a personal or family relationship.

"(15) EVALUATION OF CREDIT RATING AGENCY BOARD.—Not later than 5 years after the date that the Board begins assigning qualified nationally recog-

*nized statistical rating organizations to provide initial ratings, the Commission shall submit to Congress a report that provides recommendations of—*

*"(A) the continuation of the Board;*

*"(B) any modification to the procedures of the Board; and*

*"(C) modifications to the provisions in this subsection.".*

Commissioner Aguilar
Commissioner Paredes
not participating

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64472 / May 11, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-11701**

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| **In the Matter of**<br><br>**INVESCO FUNDS GROUP, INC.,**<br><br>**Respondent.** | **ORDER AMENDING DISTRIBUTION PLAN AND DIRECTING DISBURSEMENT** |

On July 6, 2007, the Commission published a notice of the Plan of Distribution ("Plan") proposed by the Division of Enforcement in connection with this proceeding involving Respondent Invesco Funds Group, Inc. ("IFG"). See Exch. Act Rel. No. 56025A. The Commission received comments and, on May 23, 2008, the Commission approved the proposed Plan as modified. See Exch. Act Rel. No. 57860.

The Plan provides that a Fair Fund ("IFG Fair Fund") consisting of $325,000,000 in disgorgement and civil penalties, plus any accrued interest, less any amounts necessary to pay taxes due on Fair Fund earnings, together with any payments related to other fair fund plans, be transferred to Deutsche Bank Trust Company Americas (the "Bank") to be distributed by the Fund Administrator to injured investors of specific Invesco mutual funds (the "Invesco Funds") according to the methodology set forth in the Plan.

On November 20, 2009, the Commission ordered the transfer of the IFG Fair Fund monies, together with accrued interest of $38,572,500.16, and funds totaling $54,555,132.18 associated with two other fair fund plan payments, to the Bank and further ordered the Fund Administrator to then distribute all such monies totaling $418,127,632.34 to investors as provided for in the Plan. See Exch. Act Rel. No. 60292A. The Independent Distribution Consultant ("IDC") and the Fund Administrator subsequently distributed this amount to investors beginning on December 11, 2009. The Plan provides that any monies not distributed directly to investors (the "Residual")[1] shall be distributed to the Invesco Funds in the same proportion as the amount of harm calculated on a fund-by-fund basis.

[1] This amount is net of any tax reserve, which will remain in the account pending satisfaction of tax liabilities.

A portion of the Residual is comprised of approximately $3.7 million in Fair Fund monies that the Fund Administrator had originally distributed to an intermediary for application among the beneficial accountholders of an omnibus account that had been transferred to the intermediary from an acquired business. The intermediary subsequently returned this amount to the Fair Fund due to its inability, at that time, to extract the necessary information from the acquired business' primary system of records that would otherwise enable the intermediary to identify the beneficial accountholders of that account. However, the intermediary has since informed the Commission staff that it may be able to provide the Fund Administrator with the necessary information through its search of a second set of records that the acquired business had maintained. Consistent with the Plan's primary object to distribute funds to affected investors at the time of the misconduct and with the concurrence of the IDC and Invesco, the Plan is amended as follows:

A. Additional Steps: The intermediary noted above, with the assistance of Invesco, the IDC, the Fund Administrator, and the Commission staff, if applicable, shall make further commercially reasonable best efforts under Section 8(a) of the Plan to provide the Fund Administrator with all available data concerning any identifying information of the omnibus account's beneficial accountholders (the "Additional Steps"). The intermediary shall employ such Additional Steps and provide any resulting data to the Fund Administrator within sixty (60) days after the issuance of this Order Amending Distribution Plan and Directing Disbursement.

B. Issuance of Checks: No later than ten (10) business days after the completion of the Additional Steps, the IDC and Fund Administrator shall issue and mail checks to any beneficial accountholders that are identified as a result of the Additional Steps.

C. Stale Dates for Issued Checks: Checks issued as a result of the Additional Steps shall have a stale date of 60 days after issuance. The IDC may, in his discretion, re-issue a check which was issued pursuant to this authorization, but only if the request for re-issuance is made before the stale date of the original check (i.e., within 60 days after the original issuance). Any check so re-issued will have a stale date no later than 30 days after the stale date of the originally issued check.

D. Costs of Additional Steps: Invesco will pay, but shall be reimbursed from the Fair Fund, for the fees and expenses of the IDC and Fund Administrator that are attributable to the Additional Steps which are found not to be unreasonable by the Commission staff. Such reimbursable costs, however, are not to exceed $500,000 ("Total Reimbursable Amount"). Fees and expenses of the IDC and the Fund Administrator which are not attributable to the Additional Steps, as determined by the staff of the Commission, shall be borne by Invesco in accordance with the Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange

Act of 1934, Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, dated October 8, 2004, and shall not be reimbursed from the Fair Fund. Accordingly, fees and expenses attributable to the Additional Steps but which exceed the Total Reimbursable Amount shall not be reimbursed.

E. Amount to be Reserved from the Residual: The amount of $4.2 million will be reserved from the Fair Fund ("Reserved Amount") to pay: (1) any check issuances that result from the Additional Steps; (2) the Total Reimbursable Amount of the Additional Steps as described above; and (3) estimated tax liabilities of the Fair Fund.

F. The Residual Distribution: The current balance of the Fair Fund less the Reserved Amount shall be considered the Residual and shall be distributed to the affected Invesco Funds in accordance with the Plan. Those Residual distributions may be made while the Additional Steps are being taken.

G. Remaining Reserved Amount to be Disbursed to Treasury: Any checks issued pursuant to the Additional Steps which remain uncashed after their stale date or which are returned as undeliverable, shall be cancelled and returned to the Fair Fund. This amount plus any monies remaining from Reserved Amount shall then be disbursed to Treasury in accordance with Step 26 of the Plan.

Finally, the Plan provides for a process by which the IDC is to determine whether individuals or entities suspected of having market timing arrangements with IFG are nonetheless eligible for a distribution from the IFG Fair Fund. After the Fund Administrator had distributed the Fair Fund monies noted above following the Commission's November 20, 2009 Order, the IDC determined that fifty-eight (58) additional investors were eligible to receive a distribution under this process and quantified their estimable distribution from the Fair Fund monies using a distribution methodology that is not otherwise described in the Plan. Because the Commission finds that this alternative methodology results in a reasonable approximation of these investors' payments from the IFG Fair Fund, the Commission amends the Plan to allow the IDC's use of this alternative distribution methodology and authorizes the IDC to distribute the quantified payments to such investors from the Fair Fund monies. Any checks issued as a result of this distribution shall have a stale date of 60 days after their issuance. The IDC may, in his discretion, re-issue a check which was issued pursuant to this authorization, but only if the request for re-issuance is made before the stale date of the original check (i.e., within 60 days after the original issuance). Any check so re-issued will have a stale date no later than 30 days after the stale date of the originally issued check. Except as provided in this paragraph, the IDC will not authorize any other payments. Finally, any issued checks which remain uncashed after their stale date or which are returned as undeliverable, shall be cancelled and returned to Fair Fund to be disbursed to Treasury in accordance with Step 26 of the Plan.

Accordingly, it is ORDERED that:

1. Pursuant to Rule 1105(g) of the Fair Fund Rules, 17 C.F.R. §201.1105(g), that the Plan is amended as described above, and approved with such amendments;

2. The Fund Administrator shall disburse the Residual as described in Paragraph F., above, to the affected Invesco Funds in the amount stated in the validated payment file of $57,821,352.37; and

3. The Fund Administrator shall disburse payments to the 58 eligible investors referenced above from the IFG Fair Fund based on the IDC's use of the approved alternative distribution methodology in the amount stated in the validated payment file of $26,838.97.

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. 64468 / May 11, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3200 / May 11, 2011**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 29667 / May 11, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-12574**

**In the Matter of**

**MELHADO, FLYNN & ASSOCIATES, INC., GEORGE M. MOTZ AND JEANNE MCCARTHY**

**Respondents.**

**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO JEANNE MCCARTHY**

**I.**

On February 26, 2007, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against respondents, including Jeanne McCarthy ("McCarthy" or "Respondent").

**II.**

Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-And-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 as to Jeanne McCarthy ("Order"), as set forth below.

## III.

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

**Summary**

1. These proceedings arise out of fraudulent trade allocation – or "cherry-picking" – at Melhado, Flynn & Associates, Inc. ("MFA"). From at least January 2001 through April 2005 (the "relevant period"), the President and Chief Executive Officer of MFA ("MFA's CEO"), engaged in cherry-picking at MFA. MFA was a registered broker-dealer and investment adviser at the time. During the initial period of the scheme – January 2001 until approximately September 2003 – MFA's CEO unfairly allocated trades that had appreciated in value during the course of the day to MFA's proprietary trading account and allocated purchases that had depreciated in value during the day to the accounts of his advisory clients. Beginning in the summer of 2003, MFA's CEO engaged in cherry-picking to favor one of the firm's advisory clients, a hedge fund affiliated with MFA, over his other advisory clients. MFA's CEO accomplished this cherry-picking by purchasing securities toward the beginning of the trading day but waiting until later in the day – after he saw whether the securities appreciated in value – to allocate the securities. MFA's CEO was able to generate approximately $1.4 million in profits through this scheme. In the fall of 2003, MFA's CEO with the assistance of McCarthy, altered order tickets in an attempt to cover-up these fraudulent trade allocations. In addition, MFA and its CEO earned commissions and fees from advisory clients who were disadvantaged, and therefore harmed, by the cherry-picking scheme. Neither MFA nor its CEO disclosed to clients that the firm was engaged in cherry-picking and that the firm would favor itself in the allocation of appreciated securities. Nor did they disclose that the firm engaged in cherry-picking to favor an advisory client hedge fund over other advisory clients. MFA also violated and MFA's CEO and McCarthy aided, abetted and caused violations of the books and records provisions of both the Advisers Act and the Exchange Act.

**Respondent**

2. Jeanne McCarthy, age 59, was Financial and Operations Principal during the relevant period. From approximately August 2003 through at least the end of the relevant period, she was also the Director of Compliance Coordination ("DCC") at MFA. McCarthy had been the CEO's administrative assistant for 20 years prior to becoming DCC. When called for testimony by the Division of Enforcement, McCarthy invoked her Fifth Amendment privilege and refused to answer questions. During the relevant period she resided in New York City; she currently resides in Plymouth, Michigan.

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

## Other Relevant Entities

3. Melhado, Flynn & Associates, Inc., a New York corporation, is a registered broker-dealer (since December 29, 1976) and investment adviser (since February 18, 1977). Until it stopped doing business, its main office was located in New York, New York. As of the end of the relevant period, MFA had approximately $318.2 million in assets under management and 749 advisory client accounts; the firm had discretionary control over 734 of those accounts whose assets totaled $249.2 million. MFA's clients included, among others, individuals, trusts and pension plans.

4. Third Millennium Fund, L.P. ("Third Millennium"), a Delaware limited partnership, was formed in March 2002. The fund's shares are exempted from registration with the Commission under Regulation D of the Securities Act. Third Millennium GP, LLC, serves as a general partner of Third Millennium. MFA and MFA's CEO, among others, were members of the general partner. During the relevant period, MFA's CEO was responsible for investing a portion of the Third Millennium assets. During the relevant period, investors in the fund included high net worth individuals, some of whom were also advisory clients of MFA. Another advisory client opened an account with MFA pursuant to an agreement that the trading in its account would emulate the trading of Third Millennium (the "companion account").

## The Cherry-Picking Scheme at MFA and McCarthy's Misconduct

5. From 2001 through approximately September 2003, MFA's CEO engaged in a cherry-picking scheme that generated virtually risk-free profits for the firm's trading account at the expense of the firm's advisory clients. MFA's CEO, the only MFA employee who executed trades in the firm's proprietary account, engaged in day-trading in that account. MFA's CEO was able to generate approximately $1.4 million in profits through this scheme. Then, beginning in the summer of 2003 and until at least May 2005, MFA's CEO engaged in cherry-picking to boost the returns of the Third Millennium, an advisory client hedge fund affiliated with MFA. During this period, MFA's CEO had trading responsibility for a portion of Third Millennium's assets.

6. To effectuate the cherry-picking scheme, MFA's CEO typically submitted equity buy orders to the MFA trading desk in the morning without indicating the accounts to which those purchases should be allocated. MFA's CEO did not provide the trading desk with allocation instructions concerning those purchases until much later in the day – often shortly before the close of the market. Thus, MFA's CEO purchased securities in the morning and then decided later in the day whether to sell the position and book the profit in MFA's proprietary account or to allocate the securities, often those which had depreciated in value during the day, to advisory client accounts.

7. Trading records for MFA's proprietary account for January 2001 through September 2003 show that nearly every trade that MFA's CEO allocated to MFA's proprietary account during this period had appreciated in value from the time it was purchased earlier in the day. Through this cherry-picking scheme, MFA's CEO executed day-trades in MFA's proprietary account that were more than 98% profitable and yielded a net gain of close to $1.4 million.

8. In June 2003, MFA's CEO began to engage in cherry-picking to boost the returns of Third Millennium. During the period from December 18, 2003 through May 9, 2005, Third Millennium had a number of trades that were opened and closed out on the same or the next trading day. The profitability of such trades conducted in the Third Millennium account during this period was 100%. MFA's CEO also favored the companion account in the allocation of securities during this period. The profitability of the trades that were opened and closed out on the same or the next trading day in the companion account was over 98%.

9. As a result of the unfair allocations during the relevant period, MFA earned approximately $1.4 million in profit. In addition, MFA and its CEO received significant management fees and commissions from their advisory clients who were disadvantaged, and therefore harmed, by the cherry-picking scheme.

10. During an SEC examination of MFA in the fall of 2003, MFA's CEO, with the assistance of McCarthy, altered certain order tickets relating to the cherry-picked trades in order to try to conceal his fraudulent practices from regulators. Specifically, MFA's CEO, with the assistance of McCarthy, gathered relevant order tickets from their designated locations and altered some of the tickets by adding markings or changing existing markings to make it appear that allocations had been made at the time of the initial purchases rather than later in the day.

11. During the time of the order ticket alteration, McCarthy was aware of MFA's CEO's late-day allocation practices. In addition, at the time of the order ticket alteration, McCarthy held a compliance role at MFA. Thus, by assisting in the alteration of these order tickets, McCarthy substantially assisted the ongoing fraudulent scheme.

12. MFA failed to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client. When submitting his initial trades, MFA's CEO failed to indicate the account for which the trades were entered, sometimes leaving the customer name field blank on order tickets. In addition, MFA's CEO and McCarthy were involved in the alteration of order tickets which rendered the memoranda inaccurate.

## Violations

13. As a result of the conduct described above, McCarthy willfully aided and abetted and caused MFA and MFA's CEO's violations of 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. In addition, through this cherry-picking scheme and by failing to disclose the scheme, McCarthy willfully aided and abetted and caused MFA's violations of Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser with respect to advisory clients or prospective clients.

14. As a result of the conduct described above, McCarthy willfully aided and abetted and caused MFA's violations of Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(6)(i) thereunder which require registered investment advisers and broker-dealers to make and keep true, accurate and

current order memoranda for the purchase and sale of any security on behalf of a client by failing to make accurate order tickets that contained all the information required by those rules. In addition, McCarthy willfully aided and abetted and caused MFA's violations of Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(1) thereunder, by subsequently assisting in the CEO's alteration of order tickets.

**Civil Penalties**

15. Respondent has submitted a sworn Statement of Financial Condition dated September 8, 2010 and other evidence and has asserted her 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 Respondent Jeanne McCarthy's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent McCarthy shall cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 17(a)(1) of the Exchange Act and Rules 10b-5, 17a-3(a)(6)(i) and 17a-4(b)(1) thereunder, Sections 204, 206(1) and 206(2) of the Advisers Act and Rule 204-2(a)(3) thereunder;

B. Respondent McCarthy be, and hereby is barred from association with any broker, dealer, or investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

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. Based upon Respondent's sworn representations in her Statement of Financial Condition dated September 8, 2010 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent.

E. The Division of Enforcement may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
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. 64467 / May 11, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3199 / May 11, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-12574

| In the Matter of<br><br>MELHADO, FLYNN & ASSOCIATES, INC., GEORGE M. MOTZ AND JEANNE MCCARTHY<br><br>Respondents. | ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AS TO MELHADO, FLYNN & ASSOCIATES, INC. |
|---|---|

I.

On February 26, 2007, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against respondents, including Melhado, Flynn & Associates, Inc. ("MFA" or "Respondent").

II.

Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over 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 and a Cease-And-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 as to Melhado, Flynn & Associates, Inc. ("Order"), as set forth below.

## III.

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

**Summary**

1. These proceedings arise out of fraudulent trade allocation – or "cherry-picking" – at MFA. From at least January 2001 through April 2005 (the "relevant period") the President and Chief Executive Officer of MFA ("MFA's CEO"), engaged in cherry-picking at MFA. MFA was a registered broker-dealer and investment adviser at the time. During the initial period of the scheme – January 2001 until approximately September 2003 – MFA's CEO unfairly allocated trades that had appreciated in value during the course of the day to MFA's proprietary trading account and allocated purchases that had depreciated in value during the day to the accounts of his advisory clients. Beginning in the summer of 2003, MFA's CEO engaged in cherry-picking to favor one of the firm's advisory clients, a hedge fund affiliated with MFA, over his other advisory clients. MFA's CEO accomplished this cherry-picking by purchasing securities toward the beginning of the trading day but waiting until later in the day – after he saw whether the securities appreciated in value – to allocate the securities. MFA's CEO was able to generate approximately $1.4 million in profits through this scheme. In the fall of 2003, MFA's CEO with the assistance of another MFA employee, altered order tickets in an attempt to cover-up these fraudulent trade allocations. In addition, MFA and MFA's CEO earned commissions and fees from advisory clients who were disadvantaged, and therefore harmed, by the cherry-picking scheme. Neither MFA nor MFA's CEO disclosed to clients that the firm was engaged in cherry-picking and that the firm would favor itself in the allocation of appreciated securities. Nor did they disclose that the firm engaged in cherry-picking to favor an advisory client hedge fund over other advisory clients. MFA also violated and MFA's CEO and another MFA employee aided, abetted and caused violations of the books and records provisions of both the Advisers Act and the Exchange Act.

**Respondent**

2. Melhado, Flynn & Associates, Inc., a New York corporation, is a registered broker-dealer (since December 29, 1976) and investment adviser (since February 18, 1977). Until it stopped doing business, its main office was located in New York, New York. As of the end of the relevant period, MFA had approximately $318.2 million in assets under management and 749 advisory client accounts; the firm had discretionary control over 734 of those accounts whose assets totaled $249.2 million. MFA's clients included, among others, individuals, trusts and pension plans. In October 2009, MFA pled guilty to one count of securities fraud relating to the cherry-picking alleged in these proceedings. MFA was later sentenced to five years probation.

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

## Other Relevant Entity

3. Third Millennium Fund, L.P. ("Third Millennium"), a Delaware limited partnership, was formed in March 2002. The fund's shares are exempted from registration with the Commission under Regulation D of the Securities Act. Third Millennium GP, LLC, serves as a general partner of Third Millennium. MFA and MFA's CEO, among others, were members of the general partner. During the relevant period, MFA's CEO was responsible for investing a portion of the Third Millennium assets. During the relevant period, investors in the fund included high net worth individuals, some of whom were also advisory clients of MFA. Another advisory client opened an account with MFA pursuant to an agreement that the trading in its account would emulate the trading of Third Millennium (the "companion account").

## Background

4. From 2001 through approximately September 2003, MFA's CEO engaged in a cherry-picking scheme that generated virtually risk-free profits for the firm's trading account at the expense of the firm's advisory clients. MFA's CEO, the only MFA employee who executed trades in the firm's proprietary account, engaged in day-trading in that account. MFA's CEO was able to generate approximately $1.4 million in profits through this scheme. Then, beginning in the summer of 2003 and until at least May 2005, MFA's CEO engaged in cherry-picking to boost the returns of the Third Millennium, an advisory client hedge fund affiliated with MFA. During this period, MFA's CEO had trading responsibility for a portion of Third Millennium's assets.

5. To effectuate the cherry-picking scheme, MFA's CEO typically submitted equity buy orders to the MFA trading desk in the morning without indicating the accounts to which those purchases should be allocated. MFA's CEO did not provide the trading desk with allocation instructions concerning those purchases until much later in the day – often shortly before the close of the market. Thus, MFA's CEO purchased securities in the morning and then decided later in the day whether to sell the position and book the profit in MFA's proprietary account or to allocate the securities, often those which had depreciated in value during the day, to advisory client accounts.

6. Neither MFA's CEO nor MFA disclosed to clients that the firm was engaged in cherry-picking and that the firm would favor itself in the allocation of appreciated securities. Nor did MFA or MFA's CEO disclose to clients that the firm engaged in cherry-picking to favor Third Millennium over other advisory clients. In fact, the firm's ADV disclosures during the relevant period indicated that clients would not be disadvantaged by the firm's proprietary trading.

7. Trading records for MFA's proprietary account for January 2001 through September 2003 show that nearly every trade that MFA's CEO allocated to MFA's proprietary account during this period had appreciated in value from the time it was purchased earlier in the day. Through this cherry-picking scheme, MFA's CEO executed day-trades in MFA's proprietary account that were more than 98% profitable and yielded a net gain of close to $1.4 million.

8. Performance data for the proprietary account was used by MFA employees to solicit investments in Third Millennium.

9. MFA's CEO was advised by others in the firm that he should allocate his trades at the time he submitted the order but through at least April 2005, MFA's CEO did not change his allocation practices.

10. In June 2003, MFA's CEO began to engage in cherry-picking to boost the returns of Third Millennium. During the period from December 18, 2003 through May 9, 2005, Third Millennium had a number of trades that were opened and closed out on the same or the next trading day. The profitability of such trades conducted in the Third Millennium account during this period was 100%. MFA's CEO also favored the companion account in the allocation of securities during this period. The profitability of the trades that were opened and closed out on the same or the next trading day in the companion account was over 98%. Consequently, MFA's CEO continued to harm certain MFA advisory clients by consistently allocating profitable trades to Third Millennium and the companion account during this period.

11. As a result of the unfair allocations during the relevant period, MFA earned approximately $1.4 million in profit. In addition, MFA and MFA's CEO received significant management fees and commissions from their advisory clients who were disadvantaged, and therefore harmed, by the cherry-picking scheme.

12. During an SEC examination of MFA in the fall of 2003, MFA's CEO, with the assistance of another MFA employee, altered certain order tickets relating to the cherry-picked trades in order to try to conceal his fraudulent practices from regulators. Specifically, MFA's CEO, with the assistance of another MFA employee, gathered relevant order tickets from their designated locations and altered some of the tickets by adding markings or changing existing markings to make it appear that allocations had been made at the time of the initial purchases rather than later in the day.

13. MFA failed to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client. When submitting his initial trades, MFA's CEO failed to indicate the account for which the trades were entered, sometimes leaving the customer name field blank on order tickets. In addition, MFA's CEO and another MFA employee were involved in the alteration of order tickets which rendered the memoranda inaccurate.

14. MFA's CEO signed and caused to be filed with the Commission on behalf of MFA materially misleading Forms ADV. Specifically, in response to Item 9 of Part II of MFA's Forms ADV filed during the relevant period, the firm acknowledged that it "buys and sells for itself securities that it also recommends to clients." An investment adviser that answers "yes" to that question is then required to disclose on Schedule F "what restrictions or internal procedures, or disclosures are used for conflicts of interest in" transactions in which it buys or sells for itself the same securities that it recommends to clients. Rather than disclosing its internal procedures, MFA disclosed only that "[t]he Investment Advisor might be purchasing or selling the same security for his/her own account as that of the client's in which case the Investment Advisor account never receives a lower price in cases of a purchase or a higher price in cases of a sale." Accordingly, as

MFA and MFA's CEO willfully made material misstatements in the Forms ADV for the relevant period, these Forms ADV were misleading.

15. From October 5, 2004 through at least April 2005, MFA was an investment adviser registered with the Commission that failed to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons. This failure permitted MFA's CEO to continue his allocation practices and cherry-pick trades to favor Third Millennium.

16. On October 15, 2009, MFA pled guilty to one count of securities fraud in violation of Title 18 United States Code, Sections 1348(1), (2) and 3551, et seq. before the United States District Court for the Eastern District of New York, in United States v. Motz, 08-CR-598 (ADS) (the "Criminal Case"). On April 28, 2010, a judgment in the Criminal Case was entered against MFA, sentencing it to five years probation. MFA did not appeal the judgment.

**Violations**

17. As a result of the conduct described above, MFA 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. In addition, through this cherry-picking scheme and by failing to disclose the scheme, MFA willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser with respect to advisory clients or prospective clients.

18. As a result of the conduct described above, MFA willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(6)(i) thereunder which require registered investment advisers and broker-dealers to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client by failing to make accurate order tickets that contained all the information required by those rules. In addition, MFA willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(1) thereunder, by subsequently altering order tickets. MFA also willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(2) thereunder, and Section 17(a)(1) of the Exchange Act and Rules 17a-3(a)(2) and 17a-4(a) thereunder, by failing to create and maintain a general ledger for substantial portions of the relevant period. And MFA willfully violated Section 204 of the Advisers Act and Rule 204-2(a)(6) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(5) thereunder, by failing to maintain a record of a trial balance during much of the relevant period. MFA also willfully violated Section 207 of the Advisers Act, by filing misleading Forms ADV that willfully made material misstatements – *i.e.*, falsely asserting that when MFA buys or sells for itself the same securities that it recommends to clients, it "never receives a lower price in cases of a purchase or a higher price in cases of a sale." Finally, MFA willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, by failing to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.

**Disgorgement and Civil Penalties**

19. Respondent has asserted its inability to pay either disgorgement or a civil penalty and submitted both to the court in the Criminal Case and to the Commission evidence of its inability to pay. Among other things, MFA has effectively been out of business since early 2008, has not paid New York State taxes since 2007, and has virtually no assets (although it does have liabilities).

**IV.**

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent MFA shall cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 17(a)(1) of the Exchange Act and Rules 10b-5, 17a-3(a)(6)(i), 17a-3(a)(2), 17a-4(a), 17a-4(b)(1), and 17a-4(b)(5) thereunder, and Sections 204, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2(a)(2), 204-2(a)(3), 204-2(a)(6), and 206(4)-7 thereunder;

B. The registrations of Respondent MFA as a broker, dealer and investment adviser with the Commission be, and hereby are, revoked;

C. Based upon evidence of its inability to pay submitted both to the court in the Criminal Case and to the Commission, the Commission is not imposing disgorgement against Respondent.

D. Based upon evidence of its inability to pay submitted both to the court in the Criminal Case and to the Commission, and given the Commission's revocation of Respondent's registrations as a broker, dealer and investment adviser, as well as the sentence of five years of probation imposed on Respondent in the Criminal Case, the Commission is not imposing a penalty against Respondent.

E. The Division of Enforcement 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 disgorgement and pre-judgment interest and/or the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
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. 64469 / May 11, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3201 / May 11, 2011**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 29668 / May 11, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-12574**

**In the Matter of**

**MELHADO, FLYNN & ASSOCIATES, INC., GEORGE M. MOTZ AND JEANNE MCCARTHY**

**Respondents.**

**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO GEORGE M. MOTZ**

**I.**

On February 26, 2007, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against respondents, including George M. Motz ("Motz" or "Respondent").

**II.**

Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-And-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 as to George M. Motz ("Order"), as set forth below.

## III.

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

**Summary**

1. These proceedings arise out of fraudulent trade allocation – or "cherry-picking" – at Melhado, Flynn & Associates, Inc. ("MFA"). From at least January 2001 through April 2005 (the "relevant period") Motz, the President and CEO of MFA, engaged in cherry-picking at MFA. MFA was a registered broker-dealer and investment adviser at the time. During the initial period of the scheme – January 2001 until approximately September 2003 – Motz unfairly allocated trades that had appreciated in value during the course of the day to MFA's proprietary trading account and allocated purchases that had depreciated in value during the day to the accounts of his advisory clients. Beginning in the summer of 2003, Motz engaged in cherry-picking to favor one of the firm's advisory clients, a hedge fund affiliated with MFA, over his other advisory clients. Motz accomplished this cherry-picking by purchasing securities toward the beginning of the trading day but waiting until later in the day – after he saw whether the securities appreciated in value – to allocate the securities. Motz was able to generate approximately $1.4 million in profits through this scheme. In the fall of 2003, Motz with the assistance of another MFA employee, altered order tickets in an attempt to cover-up these fraudulent trade allocations. In addition, MFA and Motz earned commissions and fees from advisory clients who were disadvantaged, and therefore harmed, by the cherry-picking scheme. Neither MFA nor Motz disclosed to clients that the firm was engaged in cherry-picking and that the firm would favor itself in the allocation of appreciated securities. Nor did they disclose that the firm engaged in cherry-picking to favor an advisory client hedge fund over other advisory clients. MFA also violated and Motz and another MFA employee aided, abetted and caused violations of the books and records provisions of both the Advisers Act and the Exchange Act.

**Respondent**

2. George M. Motz, age 68, began working at MFA on June 4, 1979. During the relevant period, Motz was President, CEO, Director, and Chief Compliance Officer of MFA. In addition, he was a 9.3% equity owner of MFA. During the relevant period, Motz managed approximately 183 discretionary accounts and six non-discretionary accounts, which had assets at MFA of approximately $58.9 million and $19.6 million respectively. Motz earned over $300,000 annually from MFA during the relevant period. During the relevant period, Motz held Series 1, 24 and 40 licenses with the NASD. When called for testimony by the Division of Enforcement, Motz invoked his Fifth Amendment privilege and refused to answer questions. In October 2009, Motz pled guilty to one count of securities fraud relating to the cherry-picking alleged in these

[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.

proceedings. Motz was later sentenced to eight years in prison and ordered to pay restitution of approximately $865,000. Motz is currently incarcerated at the Federal Correctional Institution in Otisville, New York.

## Other Relevant Entities

3. Melhado, Flynn & Associates, Inc., a New York corporation, is a registered broker-dealer (since December 29, 1976) and investment adviser (since February 18, 1977). Until it stopped doing business, its main office was located in New York, New York. As of the end of the relevant period, MFA had approximately $318.2 million in assets under management and 749 advisory client accounts; the firm had discretionary control over 734 of those accounts whose assets totaled $249.2 million. MFA's clients included, among others, individuals, trusts and pension plans.

4. Third Millennium Fund, L.P. ("Third Millennium"), a Delaware limited partnership, was formed in March 2002. The fund's shares are exempted from registration with the Commission under Regulation D of the Securities Act. Third Millennium GP, LLC, serves as a general partner of Third Millennium. MFA and Motz, among others, were members of the general partner. During the relevant period, Motz was responsible for investing a portion of the Third Millennium assets. During the relevant period, investors in the fund included high net worth individuals, some of whom were also advisory clients of MFA. Another advisory client opened an account with MFA pursuant to an agreement that the trading in its account would emulate the trading of Third Millennium (the "companion account").

## Background

5. From 2001 through approximately September 2003, Motz engaged in a cherry-picking scheme that generated virtually risk-free profits for the firm's trading account at the expense of the firm's advisory clients. Motz, the only MFA employee who executed trades in the firm's proprietary account, engaged in day-trading in that account. Motz was able to generate approximately $1.4 million in profits through this scheme. Then, beginning in the summer of 2003 and until at least May 2005, Motz engaged in cherry-picking to boost the returns of the Third Millennium, an advisory client hedge fund affiliated with MFA. During this period, Motz had trading responsibility for a portion of Third Millennium's assets.

6. To effectuate the cherry-picking scheme, Motz typically submitted equity buy orders to the MFA trading desk in the morning without indicating the accounts to which those purchases should be allocated. Motz did not provide the trading desk with allocation instructions concerning those purchases until much later in the day – often shortly before the close of the market. Thus, Motz purchased securities in the morning and then decided later in the day whether to sell the position and book the profit in MFA's proprietary account or to allocate the securities, often those which had depreciated in value during the day, to advisory client accounts.

7. Neither Motz nor MFA disclosed to clients that the firm was engaged in cherry-picking and that the firm would favor itself in the allocation of appreciated securities. Nor did

MFA or Motz disclose to clients that the firm engaged in cherry-picking to favor Third Millennium over other advisory clients. In fact, the firm's ADV disclosures during the relevant period indicated that clients would not be disadvantaged by the firm's proprietary trading.

8. Trading records for MFA's proprietary account for January 2001 through September 2003 show that nearly every trade that Motz allocated to MFA's proprietary account during this period had appreciated in value from the time it was purchased earlier in the day. Through this cherry-picking scheme, Motz executed day-trades in MFA's proprietary account that were more than 98% profitable and yielded a net gain of close to $1.4 million.

9. Performance data for the proprietary account was used by MFA employees to solicit investments in Third Millennium.

10. Motz was advised by others in the firm that he should allocate his trades at the time he submitted the order but through at least April 2005, Motz did not change his allocation practices.

11. In June 2003, Motz began to engage in cherry-picking to boost the returns of Third Millennium. During the period from December 18, 2003 through May 9, 2005, Third Millennium had a number of trades that were opened and closed out on the same or the next trading day. The profitability of such trades conducted in the Third Millennium account during this period was 100%. Motz also favored the companion account in the allocation of securities during this period. The profitability of the trades that were opened and closed out on the same or the next trading day in the companion account was over 98%. Consequently, Motz continued to harm certain MFA advisory clients by consistently allocating profitable trades to Third Millennium and the companion account during this period.

12. As a result of the unfair allocations during the relevant period, MFA earned approximately $1.4 million in profit. In addition, MFA and Motz received significant management fees and commissions from their advisory clients who were disadvantaged, and therefore harmed, by the cherry-picking scheme.

13. During an SEC examination of MFA in the fall of 2003, Motz, with the assistance of another MFA employee, altered certain order tickets relating to the cherry-picked trades in order to try to conceal his fraudulent practices from regulators. Specifically, Motz, with the assistance of another MFA employee, gathered relevant order tickets from their designated locations and altered some of the tickets by adding markings or changing existing markings to make it appear that allocations had been made at the time of the initial purchases rather than later in the day.

14. MFA failed to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client. When submitting his initial trades, Motz failed to indicate the account for which the trades were entered, sometimes leaving the customer name field blank on order tickets. In addition, Motz and another MFA employee were involved in the alteration of order tickets which rendered the memoranda inaccurate.

15. Motz signed and caused to be filed with the Commission on behalf of MFA materially misleading Forms ADV. Specifically, in response to Item 9 of Part II of MFA's Forms ADV filed during the relevant period, the firm acknowledged that it "buys and sells for itself securities that it also recommends to clients." An investment adviser that answers "yes" to that question is then required to disclose on Schedule F "what restrictions or internal procedures, or disclosures are used for conflicts of interest in" transactions in which it buys or sells for itself the same securities that it recommends to clients. Rather than disclosing its internal procedures, MFA disclosed only that "[t]he Investment Advisor might be purchasing or selling the same security for his/her own account as that of the client's in which case the Investment Advisor account never receives a lower price in cases of a purchase or a higher price in cases of a sale." Accordingly, as MFA and Motz willfully made material misstatements in the Forms ADV for the relevant period, these Forms ADV were misleading.

16. From October 5, 2004 through at least April 2005, MFA was an investment adviser registered with the Commission that failed to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons. This failure permitted Motz to continue his allocation practices and cherry-pick trades to favor Third Millennium.

17. On October 13, 2009, Motz pled guilty to one count of securities fraud in violation of Title 18 United States Code, Sections 1348(1), (2) and 3551, et seq. before the United States District Court for the Eastern District of New York, in United States v. Motz, 08-CR-598 (ADS) (the "Criminal Case"). On April 28, 2010, a judgment in the Criminal Case was entered against Motz, sentencing him to a prison term of 96 months followed by three years of supervised release. On August 5, 2010, the court ordered Motz to make restitution in the amount of $864,806.00. Motz is appealing the judgment and restitution order in the Criminal Case and the appeal is currently pending in the U.S. Court of Appeals for the Second Circuit.

**Violations**

18. As a result of the conduct described above, Motz 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. In addition, through this cherry-picking scheme and by failing to disclose the scheme, Motz willfully aided and abetted and caused MFA's violations of Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser with respect to advisory clients or prospective clients.

19. As a result of the conduct described above, Motz willfully aided and abetted and caused MFA's violations of Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(6)(i) thereunder which require registered investment advisers and broker-dealers to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client by failing to make accurate order tickets that contained all the information required by those rules. In addition, Motz willfully aided and abetted and caused MFA's violations of Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, and Section 17(a)(1) of the Exchange Act and

Rule 17a-4(b)(1) thereunder, by subsequently altering order tickets. Motz also willfully aided and abetted and caused MFA's violations of Section 204 of the Advisers Act and Rule 204-2(a)(2) thereunder, and Section 17(a)(1) of the Exchange Act and Rules 17a-3(a)(2) and 17a-4(a) thereunder, by failing to create and maintain a general ledger for substantial portions of the relevant period. And Motz willfully aided and abetted and caused MFA's violations of Section 204 of the Advisers Act and Rule 204-2(a)(6) thereunder, and Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(5) thereunder, by failing to maintain a record of a trial balance during much of the relevant period. Motz also willfully violated Section 207 of the Advisers Act, by signing and causing to be filed on MFA's behalf misleading Forms ADV that willfully made material misstatements – *i.e.*, falsely asserting that when MFA buys or sells for itself the same securities that it recommends to clients, it "never receives a lower price in cases of a purchase or a higher price in cases of a sale." Finally, Motz willfully aided and abetted and caused MFA's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, by failing to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.

## IV.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Motz shall cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 17(a)(1) of the Exchange Act and Rules 10b-5, 17a-3(a)(6)(i), 17a-3(a)(2), 17a-4(a), 17a-4(b)(1), and 17a-4(b)(5) thereunder, and Sections 204, 206(1), 206(2) and 207 of the Advisers Act and Rules 204-2(a)(2), 204-2(a)(3), 204-2(a)(6), and 206(4)-7 thereunder;

B. Respondent Motz be, and hereby is barred from association with any broker, dealer, or investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

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 disgorgement and prejudgment interest totaling $864,806.00. That obligation is deemed satisfied by the restitution ordered in the Criminal Case.

E. Based upon the prison sentence imposed on Respondent in the Criminal Case, the Commission is not imposing a penalty against Respondent.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

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

Chairman Schapiro not participating

**UNITED STATES OF AMERICA**
**BEFORE THE**
**SECURITIES AND EXCHANGE COMMISSION**

**Securities Act of 1933**
**Release No. 9206/May 11, 2011**

**Securities Exchange Act of 1934**
**Release No. 64462/May 11, 2011**

## ORDER DIRECTING FUNDING FOR THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD

President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") on July 21, 2010.[1] The Dodd-Frank Act, among other things, added Section 19(g) to the Securities Act of 1933 ("Securities Act") to create a mechanism for funding the Governmental Accounting Standards Board ("GASB").[2]

Section 19(g) of the Securities Act provides that the Commission may, subject to the limitations imposed by Section 15B of the Securities Exchange Act of 1934 ("Exchange Act"),[3] require a national securities association registered under the Exchange Act to establish a reasonable annual accounting support fee to adequately fund the annual budget of the GASB, and to establish rules and procedures, in consultation with the principal organizations representing State governors, legislators, local elected officials, and State and local finance officers, to provide for the equitable allocation, assessment, and collection of the accounting

1 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 See Section 978 of the Dodd-Frank Act.

3 See 15 U.S.C. 78o-4.

support fee from the members of the association, and the remittance of all such accounting support fees to the Financial Accounting Foundation.[4]

For purposes of this order and as provided in Securities Act Section 19(g), the annual budget of the GASB is the annual budget reviewed and approved according to the internal procedures of the Financial Accounting Foundation.[5] Any fees or funds collected shall be used to support the efforts of the GASB to establish standards of financial accounting and reporting recognized as generally accepted accounting principles applicable to State and local governments of the United States.[6] The annual accounting support fees collected for a fiscal year shall not exceed the recoverable annual budgeted expenses of the GASB (which may include operating expenses, capital, and accrued items).[7]

Accounting support fees collected and other receipts of the GASB shall not be considered public monies of the United States.[8] Nothing in this order shall be construed to provide the Commission or any national securities association direct or indirect oversight of the budget or technical agenda of the GASB, or affect the setting of generally accepted accounting principles by the GASB.[9] In addition, nothing in this order shall be construed to impair or limit the

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4 See 15 U.S.C. 77s(g)(1).

5 See 15 U.S.C. 77s(g)(2).

6 See 15 U.S.C. 77s(g)(3).

7 See 15 U.S.C. 77s(g)(4).

8 See 15 U.S.C. 77s(g)(5)(A).

9 See 15 U.S.C. 77s(g)(5)(B).

authority of a State or local government to establish accounting and financial reporting standards.[10]

To provide for an independent and more reliable funding mechanism for the GASB, the Commission has determined that the Financial Industry Regulatory Authority, Inc. ("FINRA") shall establish such a reasonable accounting support fee and related rules and procedures to provide funding for the GASB. Accordingly,

IT IS ORDERED, pursuant to Section 19(g) of the Securities Act, that FINRA establish (a) a reasonable annual accounting support fee to adequately fund the annual budget of the GASB; and (b) rules and procedures, in consultation with the principal organizations representing State governors, legislators, local elected officials, and State and local finance officers, to provide for the equitable allocation, assessment, and collection of the accounting support fee from its members, and the remittance of all such accounting support fees to the Financial Accounting Foundation.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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10 See 15 U.S.C. 77s(g)(5)(C).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64459 / May 11, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14377

| In the Matter of<br><br>City Network, Inc.,<br><br>Respondent. | ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934 |
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I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. City Network, Inc. ("CSNY")[1] (CIK No. 1140827) is a revoked Nevada corporation located in Jhonghe City, Taipei County, Taiwan, Province of China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CSNY 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 $3,541,458 for the prior nine months. As of May 6, 2011, the common stock of CSNY was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

B. DELINQUENT PERIODIC FILINGS

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

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

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

**III.**

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

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

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

**IV.**

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

May 11, 2011

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| **In the Matter of**<br><br>**City Network, Inc.,**<br><br>**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 City Network, Inc. because it has not filed any periodic reports since the period ended September 30, 2006.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on May 11, 2011, through 11:59 p.m. EDT on May 24, 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**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64460 / May 11, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14378**

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| **In the Matter of**<br><br>**American Resource Technologies, Inc.,**<br>**Apollo Resources International, Inc.,**<br>**Bloodhound Search Technologies, Inc.,**<br>**BlueStar Health, Inc.,**<br>**Columbus Networks Corp.,**<br>**Continental Fuels, Inc.,**<br>**Data Race, Inc.,**<br>**Golden Oil Co., and**<br>**Ness Energy International, Inc.,**<br><br>**Respondents.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934** |

**I.**

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents American Resource Technologies, Inc., Apollo Resources International, Inc., Bloodhound Search Technologies, Inc., BlueStar Health, Inc., Columbus Networks Corp., Continental Fuels, Inc., Data Race, Inc., Golden Oil Co., and Ness Energy International, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. American Resource Technologies, Inc. ("ARUR") [1] (CIK No. 752391) is a Kansas corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ARUR is delinquent in its periodic

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

filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2009, which reported a net loss of $394,684 for the prior nine months. As of May 6, 2011, the common stock of ARUR was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Apollo Resources International, Inc. ("AOOR") (CIK No. 1048237) is an expired Utah corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AOOR 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 $63,435,237 for the prior nine months. As of May 6, 2011, the common stock of AOOR was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Bloodhound Search Technologies, Inc. ("BLDH") (CIK No. 1105309) is a revoked Nevada corporation located in Sugar Land, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BLDH 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 $2,237,458 for the prior nine months. As of May 6, 2011, the common stock of BLDH was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Bluestar Health, Inc. ("BLSH") (CIK No. 225926) is a delinquent Colorado corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BLSH 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 $611,207 for the prior nine months. As of May 6, 2011, the common stock of BLSH was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Columbus Networks Corporation ("CSNW") (CIK No. 1062276) is a Nevada corporation located in Austin, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CSNW 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 $522,807 for the prior nine months. As of May 6, 2011, the common stock of CSNW was quoted on OTC Link, had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. Continental Fuels, Inc. ("CNFU") (CIK No. 859365) is a revoked Nevada corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CNFU 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, 2008, which reported a net loss of $1,914,274 for the prior six months. As of May 6, 2011, the common stock of CNFU was quoted on OTC

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

7. Data Race, Inc. ("RACE") (CIK No. 890924) is a forfeited Texas corporation located in Plano, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). RACE 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 December 31, 2001, which reported a net loss of $2,035,394 for the prior six months. On June 28, 2002, RACE filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Texas, which was closed on December 18, 2007. As of May 6, 2011, the common stock of RACE was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

8. Golden Oil Co. ("GOCO") (CIK No. 350685) is a Delaware corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GOCO 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, 1998, which reported a net loss of $879,324 for the prior nine months. On May 12, 2003, GOCO filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Texas, which was awaiting closure as of May 6, 2011. As of May 6, 2011, the common stock of GOCO was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

9. Ness Energy International, Inc. ("NESS") (CIK No. 353634) is an inactive Washington corporation located in Edmond, Oklahoma with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). NESS 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, 2006, which reported a net loss of $5,244,000 for the prior year. On December 5, 2008, NESS filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Texas, which was closed on February 25, 2009. As of May 6, 2011, the common stock of NESS was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

11. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration

is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports

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

## III.

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

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

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

## IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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

**May 11, 2011**

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|---|---|
| **In the Matter of**<br><br>**American Resource Technologies, Inc.,**<br>**Apollo Resources International, Inc.,**<br>**Bloodhound Search Technologies, Inc.,**<br>**BlueStar Health, Inc.,**<br>**Columbus Networks Corp.,**<br>**Continental Fuels, Inc.,**<br>**Data Race, Inc.,**<br>**Golden Oil Co., and**<br>**Ness Energy International, Inc.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Resource Technologies, Inc. because it has not filed any periodic reports since the period ended June 30, 2009.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Apollo Resources International, 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 Bloodhound Search Technologies, 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 Bluestar Health, 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 Columbus Networks Corporation 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 Continental Fuels, Inc. because it has not filed any periodic reports since the period ended June 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Data Race, Inc. because it has not filed any periodic reports since the period ended December 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Golden Oil Co. 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 Ness Energy International, Inc. because it has not filed any periodic reports since the period ended December 31, 2006.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on May 11, 2011, through 11:59 p.m. EDT on May 24, 2011.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes not participating

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64471 / May 11, 2011**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3278 / May 11, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14379**

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| **In the Matter of**<br><br>**MICHAEL HIGGINS, CPA**<br><br>**Respondent.** | **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 that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Michael Higgins ("Higgins" 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 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 Respondent's Offer, the Commission finds[1] that:

**Summary**

1. This matter involves violations of the federal securities laws by Higgins in connection with improper revenue accruals by Michael Baker Corporation ("Michael Baker" or the "Company") which led to the material overstatement of the company's revenue and net income in Commission filings.

2. As the former Chief Financial Officer of Michael Baker's energy business segment, Baker Energy, Higgins regularly approved month-end manual journal entries that had been made by Baker Energy's Manager of Project Accounting, but did not review the supporting documentation for the manual journal entries as part of his approval process. Certain of these manual journal entries were not in accordance with generally accepted accounting principles (GAAP), resulting in the Company's material overstatements of revenue and net income in its financial statements contained in the Form 10-K for its fiscal year 2006 (filed March 16, 2007) and in the Forms 10-Q for the first three quarters of its fiscal year 2007 (filed May 8, 2007, August 7, 2007, and November 5, 2007, respectively).

3. On Friday, February 22, 2008, Michael Baker first announced through a press release posted to its website that it would restate its consolidated financial statements for the first, second and third quarters of 2007 as a result of "the improper recognition of revenue on domestic managed services projects during these periods" by Baker Energy. On June 30, 2008, Michael Baker filed its Form 10-K for fiscal year ended December 31, 2007, which included its restated financial statements for its Form 10-K filed for the fiscal year ended December 31, 2006. Subsequently, the Company restated the results of its quarterly financial statements for each of the first three quarters of 2007 in a series of restatements tied to the quarterly filings of its 2008 Forms 10-Q.

4. Michael Higgins caused Michael Baker's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-13, due to acts or omissions that he knew or should have known would contribute to such violations.

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

## Respondent

5. **Michael Higgins**, age 61, was the Chief Financial Officer in Michael Baker's Baker Energy division from 2006 to 2008. Higgins is currently self-employed as a financial and strategic consultant.

## Issuer

6. **Michael Baker Corporation** is a Pennsylvania corporation headquartered in Moon Township, Pennsylvania ("Michael Baker" or the "Company"). Michael Baker's business, at the time of the conduct at issue, was divided into two segments: Engineering and Energy. The Engineering division focused on design and consulting services primarily in the United States. The Energy division, Baker Energy, was headquartered in Houston, Texas and focused on the provision of oil related services both in the United States and abroad. Baker Energy typically generated roughly 35-40% of the Company's consolidated gross revenues.

## Background

7. Baker Energy provided labor and services to operate and maintain oil and gas production facilities owned by third parties. The improper accounting that led to the Company's restatements related to Baker Energy's work on three large projects for its clients Storm Cat Energy, J.M. Huber Corporation and Escambia Operating Company. The Storm Cat and Huber contracts were among the Company's largest contracts and including the Escambia project represented nearly eighty percent of Baker Energy's revenues.

8. For the 2006 annual reporting period and the first three quarters of 2007, the Company inappropriately overstated Baker Energy's revenue, and, as a result, the Company's consolidated financial statements for these periods materially misstated its net income. The Company overstated its consolidated net income by $1.5 million or 13% for 2006 and by $1.5 million or 49%, $2.4 million or 28%, and $1.9 million or 30% for the first, second and third quarters of 2007, respectively. These revenue overstatements caused Baker Energy to show operating income, rather than operating losses, for the first and third quarters of 2007.[2]

9. Michael Baker predominantly generated revenues on the Storm Cat, Huber and Escambia projects through "cost plus" contracts pursuant to which the Company billed the respective clients for project costs plus an agreed-upon margin. There were exceptions as to certain costs, such as vehicle costs on the Huber and Storm Cat projects that were contractually agreed to be "non-billable," meaning that the client would not reimburse Baker Energy for the

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[2] In the first quarter of 2007, Baker Energy's overstatement caused it to report $900,000 of operating income rather than $2 million of operating losses. In the third quarter of 2007, Baker Energy's overstatement caused it to report $1 million of operating income rather than $1.4 million of operating losses.

cost. In addition, one of the Storm Cat projects was a fixed-fee contract for the operation and maintenance of various wells, meaning that all of the costs on this project were "non-billable."

10. In operating the oil and gas production facilities for third parties, Baker Energy's ability to recoup costs through reimbursement depended on the terms of its contracts with the customers. Baker Energy finance employees were required to regularly review project costs and determine whether the costs were "billable" to the client or "non-billable" and accordingly record the costs in Baker Energy's Oracle Project Accounting (PA) Module on a monthly basis. If the project costs were coded as billable, then the PA Module would automatically record revenue. Because the PA Module automatically posted to the General Ledger, Baker Energy's employees were required to enter any reconciling and correcting manual journal entries to the General Ledger during each monthly close process in order to properly record the company's project costs. Typically, hundreds of manual journal adjustments were done each month.

11. As Baker Energy's CFO, Higgins was responsible for overseeing Baker Energy's Manager of Project Accounting. The Manager of Project Accounting posted entries into the PA Module as well as posted reconciling and correcting manual journal entries into the General Ledger. Higgins also was required to approve the manual journal entries posted by the Manager of Project Accounting. This approval process was a key component of Baker Energy's internal controls to prevent or detect any inappropriate manual journal entries.

12. From the fourth quarter of 2006 through the first three quarters of 2007, Baker Energy's project accounting group, led by the Manager of Project Accounting—whom Higgins as the CFO was ultimately responsible for—improperly entered costs as billable on the Storm Cat, Huber and Escambia projects and thereby caused the material misstatements that led to the company's 2008 restatement announcement.

13. Until November 2006, the Manager of Project Accounting directly reported to Baker Energy's Assistant Controller-Domestic, who reviewed and approved the proposed manual journal entries. When the Assistant Controller-Domestic left the Company in November 2006, he informed Higgins that the Manager of Project Accounting's work could not be relied on without close supervision and oversight. Although Higgins was ultimately responsible for ensuring the accuracy of the manual journal entries and knew that the Manager of Project Accounting's direct supervisor had departed, Higgins did not review any supporting documentation for the manual journal entries as part of his approval process.

14. Moreover, Higgins knew or should have known that the controls Baker Energy had in place for reviewing manual journal entries were inadequate and that they relied heavily on a monthly review by him of all of the manual journal entries. Despite readily acknowledging the inadequacy of this particular control, he took no steps to improve this particular control and failed to properly implement it as a result of his own inadequate review.

15. As a result of the conduct described above, Higgins caused Michael Baker's violations due to acts or omissions that he knew or should have known would contribute to the

following violations: Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder, which 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.

16. Also as a result of the conduct described above, Higgins caused Michael Baker's violations due to acts or omissions that he knew or should have known would contribute to violations of Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets, and caused Michael Baker's violations of Section 13(b)(2)(B) of the Exchange Act, which requires every issuer to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management's general or specific authorization; and (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets.

## IV.

In view of the foregoing, the Commission deems it appropriate to impose the relief agreed to in Respondent Michael Higgins' Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, Respondent Michael Higgins 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 Exchange Act Rules 12b-20, 13a-1, and 13a-13.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

May 12, 2011

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| **In the Matter of**<br><br>**Data Fortress Systems Group Ltd.,**<br>**Digital Youth Network Corp.,**<br>**Fantom Technologies, Inc., and**<br>**KIK Technology International, Inc.,**<br><br>**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 Data Fortress Systems Group Ltd. because it has not filed any periodic reports since the period ended June 30, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Digital Youth Network Corp. because it has not filed any periodic reports since the period ended May 31, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Fantom Technologies Inc. because it has not filed any periodic reports since the period ended June 30, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of KIK Technology International, Inc. because it has not filed any periodic reports since the period ended January 31, 2008.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on May 12, 2011 and terminating at 11:59 p.m. EDT on May 25, 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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64474 / May 12, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14380**

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| **In the Matter of**<br><br>**Data Fortress Systems Group Ltd., Digital Youth Network Corp., Fantom Technologies, Inc., and KIK Technology International, Inc.,**<br><br>**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 Data Fortress Systems Group Ltd., Digital Youth Network Corp., Fantom Technologies, Inc., and KIK Technology International, Inc.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Data Fortress Systems Group Ltd. ("DFGRF") [1] (CIK No. 943866) 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). DFGRF 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 June 30, 2002. As of May 6, 2011, the common shares of DFGRF were quoted on OTC Link, had two market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Digital Youth Network Corp. ("DYOUF") (CIK No. 1137764) is an Alberta corporation located in Vancouver, British Columbia, Canada with a class of

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

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securities registered with the Commission pursuant to Exchange Act Section 12(g). DYOUF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended May 31, 2006, which reported a net loss of $432,056 for the prior nine months. As of May 6, 2011, the common shares of DYOUF were quoted on OTC Link, had two market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Fantom Technologies Inc. ("FTMTQ") (CIK No. 864300) is an Ontario corporation located in Welland, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FTMTQ 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 June 30, 2000. As of May 6, 2011, the common shares of FTMTQ were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. KIK Technology International, Inc. ("KKTI") (CIK No. 1109662) is a suspended California corporation located in Burnaby, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). KKTI 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 January 31, 2008, which reported a net loss of $785,960 for the prior year. As of May 6, 2011, the common stock of KKTI 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

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

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 domestic issuers to file quarterly reports. Rule 13a-16 requires foreign private issuers to furnish 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.

7. 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**

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64481 / May 12, 2011

Admin. Proc. File No. 3-14093

In the Matter of the Application of

GREMO INVESTMENTS, INC.
c/o Edward Joseph Gremo, Jr.
2724 Plante Road
North Aurora, Illinois 60542

For Review of Disciplinary Action Taken by

Financial Industry Regulatory Authority, Inc.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION - REVIEW OF DISCIPLINARY PROCEEDING

**Failure to Comply with Reporting Requirements**

**Conduct Inconsistent with Just and Equitable Principles of Trade**

Member of registered securities association filed an annual report that failed to comply with reporting requirements. *Held*, association's findings of violations and sanctions imposed are *sustained.*

APPEARANCES:

*Edward Joseph Gremo, Jr.*, for Gremo Investments, Inc.

*Marc Menchel*, *Alan Lawhead*, and *Colleen E. Durbin*, for the Financial Industry Regulatory Authority, Inc.

Appeal filed: October 18, 2010
Last brief received: January 10, 2011

I.

Gremo Investments, Inc. ("Gremo Investments" or the "Firm"), a Financial Industry Regulatory Authority, Inc. ("FINRA") member firm, seeks review of disciplinary action taken by FINRA. FINRA found that the Firm violated Section 17(e) of the Securities Exchange Act of 1934 and Rule 17a-5 thereunder, and FINRA Rule 2010, by filing an annual report that was audited by an accounting firm that was not registered with the Public Company Accounting Oversight Board ("PCAOB").[1] FINRA suspended the Firm until it files a compliant annual report and imposed a $1,000 fine. We base our findings on an independent review of the record.

II.

**A. Background**

The facts are largely undisputed. Gremo Investments has been a FINRA member since October 1, 2004. The Firm is a registered broker-dealer with a net capital requirement of $5,000 and sells mutual funds and variable life insurance. Edward Gremo is the firm's chief executive officer, financial and operations principal, and chief compliance officer.

**B. The Firm Files an Annual Report.**

In a series of orders that were issued beginning in 2003, the Commission exempted non-public broker-dealers, such as the Firm, from the requirement that their annual financial statements be audited by a PCAOB-registered accounting firm.[2] Following the expiration of the Commission's exemptive orders in December 2008, FINRA sent two Information Notices to members in January and December 2009 notifying non-public broker-dealers that "[t]heir fiscal year 2009 and subsequent audits must . . . be conducted by a PCAOB-registered accounting firm."[3]

The Firm's annual report for the year ended September 30, 2009 ("2009 Annual Report") was due on November 30, 2009. The Firm retained Apple Accounting Services ("Apple

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1 15 U.S.C. § 78q; 17 C.F.R. § 240.17a-5. Rule 2010 requires members to observe "high standards of commercial honor and just and equitable principles of trade." As part of the effort to consolidate and reorganize NASD's and NYSE's rules into one FINRA rulebook, NASD Rule 2110 (which was otherwise unchanged) was codified as FINRA Rule 2010, effective December 15, 2008.

2 *See Extension of Order Regarding Broker-Dealer Financial Statement Requirements Under Section 17 of the Exchange Act*, Securities Exchange Act Rel. No. 54920 (Dec. 12, 2006), 89 SEC Docket 1672.

3 FINRA Information Notices, Dec. 9, 2009 and Jan. 8, 2009.

Accounting") to audit the financial statements in the 2009 Annual Report. On November 27, 2009, Gremo requested a thirty-day extension to file the 2009 Annual Report and explained to FINRA that Apple Accounting's PCAOB registration application was pending.[4] In a letter dated December 3, 2009, FINRA granted the extension and informed Gremo that failure to timely file the report could result in the assessment of a fine of $100 per day for up to ten days and could result in other regulatory or disciplinary action. On December 31, 2009, the Firm filed the 2009 Annual Report. Apple Accounting audited the report but was not registered with the PCAOB.[5]

### C. FINRA Initiates a Disciplinary Proceeding.

On May 3, 2010, FINRA notified Gremo and the Firm by letter that the 2009 Annual Report was incomplete because it was audited by an accounting firm that was not PCAOB registered. FINRA stated that it deemed the report not filed and that it would suspend the Firm's membership as of May 25, 2010 unless the Firm filed a compliant annual report. Among other things, FINRA advised the Firm of its right to a hearing pursuant to FINRA Rules 9552 and 9559.

On May 20, 2010, the Firm timely requested a hearing to challenge the findings of violation and the sanctions imposed. FINRA granted the request and on July 1, 2010, a FINRA Hearing Panel conducted an Expedited Proceeding telephonically. Gremo testified that he knew that the Firm was required to file an annual report that was audited by a PCAOB-registered accounting firm and that Apple Accounting was not registered with the PCAOB. In a September 17, 2010 decision, the Hearing Panel found that the Firm submitted an annual report that was audited by an accounting firm that was not PCAOB registered, that such report was incomplete, that the incomplete report was deemed not filed pursuant to FINRA's By-Laws, and that the Firm violated Exchange Act Section 17(e) and Exchange Act Rule 17a-5, and FINRA Rule 2010. The Hearing Panel upheld the suspension, fined the Firm $1,000, and imposed costs of $1,605. This appeal followed.

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4 The PCAOB received Apple Accounting's application for registration on November 30, 2009.

5 On July 13, 2010, the PCAOB issued a public notice disapproving Apple Accounting's application for registration. *Public Notice of Disapproval of Registration Application*, PCAOB Rel. No. 102-2010-005 (Jul. 13, 2010), *available at* http://pcaobus.org/registration/firms/disapproval%20notices/apple.pdf.

## III.

### A. The Firm Violated Exchange Act Section 17(e)(1)(A) and Rule 17a-5(d) thereunder, and FINRA Rule 2010.

FINRA found that the Firm violated the Exchange Act, an Exchange Act rule, and a FINRA rule and imposed a final disciplinary sanction. Accordingly, Exchange Act Section 19(e) governs our review of this proceeding.[6] Pursuant to Exchange Act Section 19(e)(1), we will sustain FINRA's disciplinary action if the record shows by a preponderance of the evidence that the Firm engaged in the violative conduct that FINRA found and that FINRA applied its rules in a manner consistent with the purposes of the Exchange Act.[7]

Exchange Act Section 17(e)(1)(A) and Rule 17a-5(d) thereunder require registered broker-dealers to file timely annual reports that contain financial statements audited by a PCAOB-registered accounting firm.[8] Gremo admits that he knew that the Firm was required to file an annual report that was audited by a PCAOB-registered accounting firm. He concedes that Apple Accounting audited the financial statements in the 2009 Annual Report and that Apple Accounting was not PCAOB registered. We conclude that the Firm violated Exchange Act Section 17(e)(1)(A) and Rule 17a-5(d) thereunder and FINRA Rule 2010.[9]

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[6] 15 U.S.C. § 78s(e)(1); *see, e.g.*, *Sky Capital LLC*, Exchange Act Rel. No. 55828 (May 30, 2007), 90 SEC Docket 2201, 2206; *Morgan Stanley & Co., Inc.*, 53 S.E.C. 379, 382 (1997).

[7] 15 U.S.C. § 78s(e)(1).

[8] 15 U.S.C. § 78q(e)(1)(A), as amended by the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 205(c)(2), 116 Stat. 745 (2002) ("Sarbanes-Oxley Act"); 17 C.F.R. § 240.17a-5(d); *see Stephen J. Horning*, Securities Exchange Act Rel. No. 56886 (Dec. 3, 2007), 92 SEC Docket 207, 223-24 (finding that respondent caused a broker-dealer's violation of Exchange Act Section 17(e) and Exchange Act Rule 17a-5(d) by filing an annual report that contained falsified financial statements), *aff'd*, 570 F.3d 337 (D.C. Cir. 2009).

[9] *See Kirlin Sec., Inc.*, Exchange Act Rel. No. 61135 (Dec. 10, 2009), 97 SEC Docket 23299, 23324 ("It is well established that a violation of . . . securities laws or regulations also constitutes a violation of Rule [2010]." (citation omitted)); *Joseph Ricupero*, Exchange Act Rel. No. 62891 (Sept. 10, 2010), 99 SEC Docket 32270, 32275 n.12 ("A violation of Exchange Act and [FINRA] Rules constitutes conduct inconsistent with just and equitable principles of trade and therefore also establishes a violation of [FINRA] Rule [2010]."), *appeal docketed*, No. 10-4566 (2d Cir. Nov. 8, 2010).

**B. The Firm's Arguments**

Gremo asserts that "the PCAOB board was ruled by the Supreme Court to be unconstitutional." The Supreme Court, however, held only that the provisions regarding removal of PCAOB members were unconstitutional.[10] All other aspects of the Sarbanes-Oxley Act remain in effect, including the PCAOB and the requirement that financial statements of broker-dealers be audited by a PCAOB-member firm.[11]

Gremo requests that the Commission "review[] the process on how new accountants become members with the PCAOB," and that "Apple [A]ccounting be approved by PCAOB, retroactively." An accounting firm that is denied registration has a right to file an appeal; however, Apple Accounting, declined to do so.[12] Apple Accounting is not a party to this proceeding, and the PCAOB's registration process with respect to Apple Accounting is not at issue here.[13] Our review is limited to FINRA's findings that Gremo Investments violated the Exchange Act and related rules and FINRA's imposition of sanctions.

Gremo claims that the PCAOB has forced him to hire a PCAOB-registered accounting firm that "charge[s] 10 times more than [the Firm's] accountant," and that "[t]his is a clear violation of the Sherman Antitrust [Act] limiting the ability of competition in the market place." Gremo fails to provide any factual support for his assertions about the increased cost of retaining a PCAOB-registered firm. Moreover, Congress, through the Sarbanes-Oxley Act amendments to the Exchange Act, mandated that financial statements of broker-dealers be audited by PCAOB-registered accountants.[14] Any financial burden the Firm bears as a result of complying with this statutory requirement is based on a Congressional determination that PCAOB registration would

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10 *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3151 (2010).

11 *See id.* at 130 S. Ct. at 3161-62 (holding that "[t]he Sarbanes-Oxley Act [which establishes the PCAOB and outlines its powers and responsibilities] remains 'fully operative as a law' with these tenure restrictions excised" (citations omitted)); *Mission Sec. Corp.*, Exchange Act Rel. No. 63453 (Dec. 7, 2010), 99 SEC Docket 35510A1, 35510A16 & n.28.

12 15 U.S.C. §§ 7215(d)(1)(C), 7217(c)(2). According to the PCAOB, Apple Accounting failed to file an appeal. *Public Notice of Disapproval of Registration Application*, PCAOB Rel. No. 102-2010-005 (Jul. 13, 2010).

13 15 U.S.C. § 78s(d). Apple Accounting is not a party or an "aggrieved person" within the meaning of Exchange Act Section 19(d)(2) for purposes of appealing the FINRA action against the Firm. *See* 15 U.S.C. § 78s(d)(2).

14 15 U.S.C. § 78q(e)(1)(A), as amended by the Sarbanes-Oxley Act; 17 C.F.R. § 240.17a-5(d); *see Horning*, 92 SEC Docket at 223.

protect the public interest by ensuring more rigorous audits.[15] In any event, the antitrust laws are impliedly repealed to the extent necessary for the Exchange Act to function in the manner Congress intended.[16] We therefore reject Gremo's claim.

Gremo seeks to have the 2009 Annual Report "stand as accepted," in part because "FINRA had a 4 day audit of [the Firm's] books and records" just one month before the 2009 Annual Report was due, and "everything was ok." The Sarbanes-Oxley Act requires the Firm to have a PCAOB-registered accounting firm audit the financial statements in the 2009 Annual Report. A FINRA examination may serve different purposes and have different goals than an audit of a Firm's financial statements by a PCAOB-registered accounting firm. FINRA routinely conducts several different types of exams designed to determine whether a member is complying with a variety of federal securities laws, rules, and regulations and FINRA rules, while an audit by a PCAOB-registered firm is meant to ensure the reliability and accuracy of the member's financial statements.[17] FINRA's inspection therefore does not provide a substitute for an audit conducted by a PCAOB-registered accounting firm or obviate the need to comply with this Congressional mandate. Moreover, whether or not FINRA detected any problems is irrelevant to our review of the violation at issue.

**IV.**

Pursuant to Exchange Act Section 19(e)(2), we will sustain FINRA's sanction unless we find, having due regard for the public interest and the protection of investors, that the sanction is excessive or oppressive or imposes an unnecessary or inappropriate burden on competition.[18] FINRA Rule 9552(a) provides that a member who fails to file an annual report will be suspended if such member fails to take corrective action.[19] Section 4(g) of Schedule A to FINRA's By-Laws

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15 Sarbanes-Oxley Act, Pub. L. No. 107-204, preamble.

16 *See Credit Suisse Sec. (USA) LLC v. Billing*, 551 U.S. 264 (2007); *Gordon v. N.Y. Stock Exch.*, 422 U.S. 659, 688-91 (1975) (stating that the "[i]mplied repeal of the antitrust laws is, in fact, necessary to make the Exchange Act work as it was intended"); *Timothy H. Emerson*, Exchange Act Rel. No. 60328 (Jul. 17, 2009), 96 SEC Docket 18882, 18894 & n.37.

17 *See* "Preparing for a FINRA Cycle Examination," *available at* http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p038336.pdf.

18 15 U.S.C. § 78s(e)(2). The Firm does not claim, and the record does not show, that FINRA's action imposes an unnecessary or inappropriate burden on competition.

19 FINRA Manual, *available at* *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4003*. FINRA

(continued...)

instructs FINRA to impose on a member a late fee of $100 for each day that an annual report is delinquent for up to a maximum of ten days.[20] FINRA suspended the Firm until it files a compliant annual report and imposed a $1,000 fine. Gremo argues that the suspension and fine are unnecessary.

The reporting provisions are important to monitor the financial status of broker-dealers and to protect investors.[21] Reporting violations are therefore serious.[22] The Commission has emphasized that the reporting rules "are not technical but involve fundamental safeguards imposed for the protection of the investing public on those who wish to engage in the securities business."[23] Congress passed the Sarbanes-Oxley Act to enhance these safeguards and "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."[24] The Sarbanes-Oxley Act established the PCAOB to oversee audits "in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports."[25] We find that the sanctions are remedial because they will impress upon the Firm and others the importance of filing annual reports that are audited by PCAOB-registered firms in compliance with the federal securities laws and protect the investing public by reducing the likelihood of any recurrence of a violation.[26]

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19 (...continued)
deemed the 2009 Annual Report to be incomplete and therefore not filed pursuant to Section 4(g) of Schedule A to FINRA's By-Laws.

20 FINRA Manual at *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4698.*

21 *See Palm State Equities, Inc.*, 52 S.E.C. 333, 338 (1995) (finding that applicant violated Exchange Act Rule 17a-5, among other things, and stating that the reporting and recordkeeping provisions are important both to monitor the financial status of broker-dealers and to protect public investors).

22 *See Troy A. Wetter*, 51 S.E.C. 763, 768 (1993) (finding applicant's failure to timely file an annual report to be a serious reporting violation).

23 *Fox & Co. Inv., Inc.*, 58 S.E.C. 873, 897 & n.50 (2005) (citing *Lowell H. Listrom*, 50 S.E.C. 883, 888 (1992)).

24 Sarbanes-Oxley Act, Pub. L. No. 107-204, preamble.

25 *http://pcaobus.org/ABOUT/Pages/default.aspx.*

26 *See Horning*, 92 SEC Docket at 223, 229 (finding that respondent caused firm's reporting, among other, violations, and that a suspension would reduce the likelihood of any recurrence).

Gremo argues that he should not have to pay costs of $1,605 because "it was never disclosed" to him when the Firm appealed to FINRA. FINRA's May 3, 2010 letter advised the Firm of its right to a hearing and instructed the Firm to refer to FINRA Rules 9552 and 9559 for further information regarding relevant procedures. Rule 9559(n) provides that FINRA may impose costs in an expedited proceeding, such as the one held here. We therefore reject Gremo's argument.[27] In any event, an associated person is assumed to have read and to have knowledge of FINRA's rules.[28] We conclude that the sanctions are neither excessive nor oppressive.

An appropriate order will issue.[29]

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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27 *See E. Magnus Oppenheim*, 58 S.E.C. 231, 243 & n.26 (2005) (rejecting applicant's claim that it should not bear costs); *John M. W. Crute*, 53 S.E.C. 1112, 1116 (1998) (recognizing NASD's broad discretion to impose costs and upholding imposition of costs), *aff'd,* 208 F.3d 1006 (5th Cir. 2000).

28 *Carter v. SEC*, 726 F.2d 472, 474 (9th Cir. 1983) (stating that registered representatives "are assumed as a matter of law to have read and have knowledge of these [*i.e.*, FINRA's] rules and requirements"); *Ryan R. Henry*, Exchange Act Rel. No. 53957 (Jun. 8, 2006), 88 SEC Docket 587, 592 n.13.

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64481 / May 12, 2011

Admin. Proc. File No. 3-14093

In the Matter of the Application of

GREMO INVESTMENTS, INC.
c/o Edward Joseph Gremo, Jr.
2724 Plante Road
North Aurora, Illinois 60542

For Review of Disciplinary Action Taken by

Financial Industry Regulatory Authority, Inc.

ORDER SUSTAINING DISCIPLINARY ACTION

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

ORDERED that the disciplinary action taken by the Financial Industry Regulatory Authority, Inc. against Gremo Investments, Inc., and its imposition of costs, be, and they hereby are, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64489 / May 13, 2011

Admin. Proc. File No. 3-13979

In the Matter of the Application of

PHILIP L. SPARTIS
and
AMY J. ELIAS
c/o Jeffrey L. Liddle, Esq.
Liddle & Robinson, L.L.P
800 Third Avenue
New York, New York 10022

For Review of Disciplinary Action Taken by

NYSE Regulation, Inc.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY PROCEEDINGS

**Failure to Comply with Public Communications Rules**

Former registered representatives of national securities exchange member firm caused violations of exchange rule by transmitting materially misleading communications to customers. *Held*, exchange's findings of violations and sanctions imposed *sustained.*

APPEARANCES:

*Jeffrey L. Liddle, David I. Greenberger,* and *David. F. Feldstein* of Liddle & Robinson, L.L.P., for Philip L. Spartis and Amy J. Elias.

*Susan Light, Allen Boyer,* and *Aida Vernon*, for Financial Industry Regulatory Authority, Inc., on behalf of NYSE Regulation, Inc.

Appeal filed: July 27, 2010
Last brief received: December 1, 2010

I.

Philip L. Spartis and Amy J. Elias ("Applicants"), former registered representatives of Salomon Smith Barney, Inc. ("Smith Barney" or the "Firm"),[1] a member of the New York Stock Exchange, LLC (hereinafter referred to, together with its regulatory subsidiary, NYSE Regulation, Inc., as "NYSE" or the "Exchange"), appeal from NYSE disciplinary action.[2] The Exchange found that Applicants caused Smith Barney to violate NYSE Rule 472.30 by sending customers communications "that omitted material facts and/or w[ere] misleading."[3] The Exchange censured Applicants. We base our findings on an independent review of the record.

II.

**A. Background**

This case concerns certain marketing materials Applicants provided to their customers, between 1998 and 2001, in connection with the customers' exercise of employee stock options that had been granted to them by WorldCom, Inc., a national telecommunications company that had grown substantially during the years preceding the period at issue.[4] In 1998, the company's stock price began to rise rapidly from $30 per share in January to $75 by year-end, eventually peaking at $96.76 in June 1999. Smith Barney research reports, issued throughout the relevant period by Firm telecommunications analyst Jack Grubman, forecasted further increases in WorldCom's stock price – predicting, for example, in twelve consecutive 1999 reports, highs of

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[1] Smith Barney is now known as Citigroup Global Markets Inc. The Firm terminated Spartis's and Elias's employment on February 4, 2002.

[2] On July 26, 2007, the Commission approved proposed rule changes in connection with the consolidation of the member firm regulatory functions of the National Association of Securities Dealers, Inc. ("NASD") and NYSE Regulation. *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. Pursuant to this consolidation, certain member firm regulatory and enforcement functions and employees of NYSE Regulation were transferred to NASD, and the expanded NASD changed its name to the Financial Industry Regulatory Authority, Inc. ("FINRA"). *See* Exchange Act Rel. No. 56148 (July 26, 2007), 91 SEC Docket 522. NYSE Regulation, which initiated this proceeding, is now represented by FINRA.

[3] NYSE Rule 472.30 prohibits the use of "any communication which contains . . . any untrue statement or omission of a material fact or is otherwise misleading." Subsequent to the events herein, in May 2002, NYSE amended Rule 472, adding restrictions on the activities of research analysts. As a result, Rule 472.30 was renumbered, without substantive change, as NYSE Rule 472(i). Exchange Act Rel. No. 45908 (May 10, 2002), 77 SEC Docket 1945.

[4] In November 1997, WorldCom merged with MCI, Inc., another national telecommunications company, more than doubling its size.

up to $130 per share.[5] Such increases, however, never materialized, as WorldCom's stock price began a steady decline at the end of 1999, closing by December 31, 2001, at $14 per share. In July 2002, WorldCom filed for bankruptcy protection, following settlement of civil fraud charges that it misled investors, from 1999 to 2002, by overstating its income.[6]

During the period at issue, Spartis and Elias served, respectively, as director of, and financial consultant in, Smith Barney's Atlanta-based Corporate Client Group (the "ACC Group"), a specialized retail unit of brokers that provided employee stock option services to the Firm's corporate clients. Under a January 1998 agreement between WorldCom and Smith Barney, WorldCom employees were required, with limited exception, to use Smith Barney's services whenever they elected to exercise their company stock options.[7]

Granted under various stock option plans, an option gave a holder the right to purchase a certain number of shares of WorldCom stock at a fixed price, commonly known as the "grant" or "strike" price. A holder could then exercise the option and thereby purchase company stock anytime on or after a vesting date, but before expiration (typically ten years from the grant date). By the early part of the period at issue, as a result of an increase in WorldCom's stock price relative to the grant price of their options, many WorldCom employees were able to exercise their options and immediately sell the stock at a substantial profit.

**B. Servicing of WorldCom's Stock Option Plans**

Smith Barney relied on the ACC Group's financial consultants to assist WorldCom's employees in the exercise of their stock options and also to sell additional brokerage services to employees in connection with the management of their assets. As head of the ACC Group, Spartis was responsible for maintaining the Firm's relationship with WorldCom and further

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5 In 2003, Grubman consented to a permanent injunction and $15 million in sanctions, in connection with his coverage, as an analyst, of the telecommunications sector from 1999 to 2001. *See SEC v. Grubman*, 03 Civ. 2938 (WHP) (S.D.N.Y. Oct. 31, 2003); *Jack Benjamin Grubman*, Exchange Act Rel. No 48725 (Oct. 31, 2003), 81 SEC Docket 2013 (barring Grubman from associating with a broker, dealer, or investment adviser).

6 *SEC v. WorldCom, Inc.*, 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003); *see also WorldCom, Inc., Sec. Litig.*, 346 F. Supp. 2d 628, 637-47 (S.D.N.Y. 2004) (discussing WorldCom's collapse and criminal indictments of several executive officers). Following its emergence from bankruptcy, in April 2004, WorldCom changed its name to MCI, Inc.

7 According to Applicants, in late 1997, Spartis "won for [Smith Barney] the exclusive right to administer" WorldCom's employee stock option plans.

expanding the group's options business.[8] Elias joined the group in early 1999 as a sales assistant, becoming a financial consultant shortly thereafter.[9]

Throughout the period at issue, Applicants fielded phone inquiries from WorldCom employees regarding their options and often continued, thereafter, providing other brokerage services to those employees. As compensation for the options business, the Firm earned a per-employee fee from WorldCom, while Applicants earned a commission of five cents per share on the sale of the customers' stock. "[M]ore importantly," Elias testified, the financial consultants sought to build on the relationships created from the options business by "offer[ing] the other services that we had, our retirement planning, our financial planning, our Smith Barney asset management." According to Elias, "the goal [with] any of the plans' optionees . . . w[as] obviously to eventually have them become a client, . . . gather assets and build out portfolios for them."[10]

**1. The Exercise-and-Hold Strategy**

Shortly after an employee contacted them with an interest in an options exercise, Applicants sent the employee a packet of introductory materials discussing, in general terms, the various exercise strategies available to them.[11] These introductory materials also provided generalized risk information, noting, for example, that a customer should "hold stock if [y]ou believe the stock will increase in value and you are willing to assume market risk"[12] and "sell stock . . . if [y]ou believe the stock price is about to decline [and] are unwilling to assume market risk."

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[8] Although he lacked formal supervisory authority, he was the ACC Group's most senior broker, generally overseeing the activities of the junior brokers and sales assistants. The ACC Group was commonly referred to, by personnel, as the "Spartis Group," or the "WorldCom Group," after its largest client.

[9] In addition to Spartis and Elias, NYSE brought proceedings against another member of the ACC Group, based on similar misconduct, which resulted in settlement.

[10] Spartis testified similarly, noting the importance of maintaining the relationship and acknowledging that his annual bonus was based, in part, on the total assets he managed.

[11] These materials were commonly referred to as the "A" pack and contained several pamphlets, including the "Seven Strategies for Maximizing your Employee Stock Options."

[12] The Firm's introductory packet further stated: "Holding the stock after exercise increases your market risk. Prior to exercise, your options carry the potential gain of the market without the risk of losing your investment, since you have made none."

The two main options strategies that Applicants discussed with employees were:

- the "exercise-and-sell strategy," whereby an employee purchased stock at the grant price and then immediately sold the resulting shares, receiving in cash the net proceeds of the stock sale, minus taxes and fees; and

- the "exercise-and-hold strategy," whereby an employee purchased stock at the grant price and held onto it for a period of time (generally, at least a year), paying the purchase price of the stock, taxes, and fees with cash or by use of a margin loan, obtained through Smith Barney.[13]

Applicants promoted the exercise-and-hold strategy over the exercise-and-sell strategy, stressing its tax benefits: if the employee exercised the options and held the stock for at least a year, any resulting profit from its subsequent sale would be taxed at a more favorable long-term capital gains rate, compared with the less favorable ordinary income tax rate, which applied if the employee exercised their options and sold the shares immediately.[14] In his hearing testimony, Spartis explained that "[w]hen these optionees were exercising [and selling their stock] they were booking tremendous gains but they're treated as ordinary income."

Choosing the exercise-and-hold strategy, nonetheless, could be costly – depending on the number of options exercised – requiring many customers to borrow funds to finance the exercise.[15] As a result, Applicants recommended margin loans (up to 50% of the market value of the stock) that would cover the purchase price of the stock, applicable taxes, and fees. Promoting the use of margin, the Firm's introductory packet noted: "Cash may seem like the quickest and easiest way to fund an exercise, but this is not necessarily true. The amount of money necessary to pay for an option exercise . . . can be quite high. It may be necessary to liquidate assets if you plan to use cash to fund your exercise." WorldCom employees who financed an options

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[13] Other strategies were available, but less frequently employed. One alternative was the "exercise and sell-to-cover" strategy, whereby the customer purchased the stock and sold enough of it to cover the purchase price of the stock, taxes, and fees, and retained the remaining shares. This strategy, like the exercise-and-sell strategy, required no margin loan. The spreadsheet-based document at issue, as discussed in Section II.B.2 below, compared only the two main strategies and did not discuss the other alternative approaches.

[14] The federal long-term capital gains rate, at the time, was 20% compared with the ordinary income tax rate that could be as high as 39.6%, depending on the employee's taxable income. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311, 111 Stat. 831 (1997) (reducing the maximum capital gains rate on net capital gains from 28% to 20%).

[15] For instance, during a taped phone conversation, a customer confirmed with Elias that "the total cost to [him] of an ex and hold is . . . $1.274 [million] plus the taxes."

transaction with margin debt were generally charged a variable interest rate of six to eight percent.[16]

Elias explained the rationale for using margin under the exercise-and-hold strategy, during a taped phone conversation with a customer, as "basically . . . betting that the stock is going to grow at a rate better than the 8% or whatever you're paying." When the customer asked Elias's opinion of the exercise-and-hold strategy, Elias described it as "one of the smartest things you can do," explaining that "[w]hen the stock pulls back like this" – *i.e.*, drops with the expectation of rising again – "it's kind of like the silver lining in the cloud as far as option exercises. If you can afford to do it or you feel comfortable using margin it makes all the sense in the world especially if you believe in the growth of [WorldCom] which we do."

The exercise-and-hold strategy, however, carried risks – primarily that the share price of WorldCom stock could decline or not appreciate sufficiently to cover the costs associated with holding the stock, including the interest on the margin loan. The Firm's introductory packet explained: "As with any securities-based loan, there is always a level of risk [to using margin]. If the value of the securities should decline, you may be required to deposit cash or additional securities, or sell a portion of your securities to pay off the loan."

In contrast, the exercise-and-sell strategy lacked market risk, as any gains amassed from the grant date of the options were locked in upon exercise and immediate sale of the stock. Unlike an exercise-and-hold transaction, customers who elected to "exercise and sell" were not required to open a Firm account and could effect the transaction, without using the ACC Group, by a voice response system, a customer service representative, or, eventually, the Internet.

### 2. The Exercise-and-Hold vs. Exercise-and-Sell Analysis

In 1998, Spartis created a spreadsheet-based document called the *Exercise & Hold vs. Exercise & Sell Analysis* (the "Options Analysis"), to better illustrate the benefits of the exercise-and-hold strategy. Spartis recounted in his on-the-record testimony that he was increasingly fielding questions "from people on what strategy would be the best for them" and "after attempting to model this on a calculator for employees as we spoke on the phone I thought it was more efficient to develop a chart that would . . . explore[] the various alternatives using the various exercise methods." Spartis, with the help of an intern, designed a template for the

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[16] Applicants provided WorldCom employees with a "preferred margin rate," by waiving their commission on the margin loan. Spartis indicated that, despite losing the transactional commission, Applicants received a small credit, year-end, on the total margin balance of their accounts.

document that could be customized and sent to customers, reflecting their specific circumstances and highlighting the potential returns under the two strategies.[17]

Generally five pages in length, the Options Analysis began with a cover page, stating that it was "intended to illustrate the benefit of exercising your options now while the stock is relatively low and then holding on to the shares for period of at least 1 year in order to take advantage of the considerably lower capital gains taxes." In calculating the employee's potential returns under the two strategies, the document stated that, "[o]f course, the most important factor . . . is that the future market value . . . at which you will sell at is higher than the current market value" and that "money is borrowed using margin for the initial cover amount to minimize the use of cash." A standard disclaimer followed at the bottom of the page, noting that the document "may not necessarily present every material fact" and that the Firm "makes no representations as to [its] completeness or accuracy."

The most prominent feature of the Options Analysis was a graph, comparing the net gains for the employee (based on the employee's available options) under the two strategies in an appreciating market for WorldCom stock. The graph showed two upwardly-trending lines at increasing future price points of WorldCom stock: one line showed the net gains under the exercise-and-hold strategy and the other line showed the net gains under the exercise-and-sell strategy. The two lines began on the x-axis, at the then-current trading price of WorldCom stock, and, as the two lines progressed rightward, they intersected at a "crossover point" – generally five to ten percentage points above the stock's current market value – where the exercise-and-hold strategy became a more profitable strategy than the exercise-and-sell strategy.

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[17] An early version of the document already existed when Spartis asked an intern to prepare an Options Analysis for a customer in early 1999. The intern testified that he improved on the template, with Spartis's approval, by making it "more legible" and adding a graph.

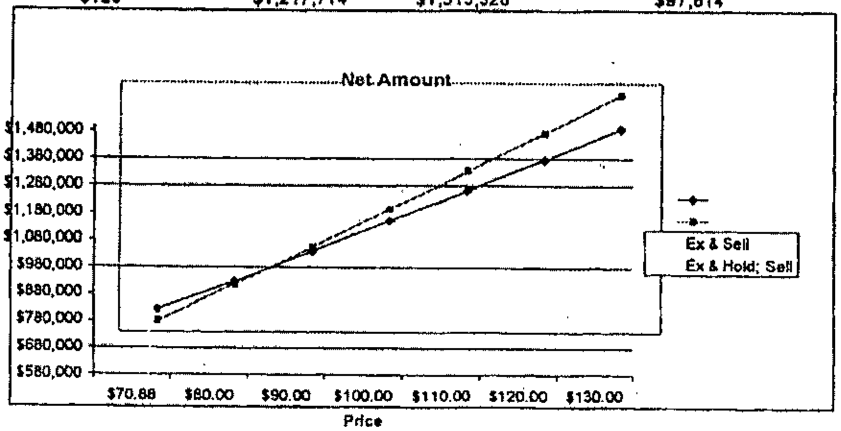
For example, the following is an Options Analysis generated for an employee on October 6, 1999, when WorldCom's share price was $70.88.

*MCI WorldCom Stock Options*

**Exercise Hold vs. Exercise Sell Analysis**

**Summary**

| | Net Amount | | |
|---|---|---|---|
| FMV | Ex & Sell | Ex & Hold; Sell | Difference |
| $71 | $663,547 | $619,765 | -$43,782 |
| $80 | $766,484 | $756,096 | -$10,388 |
| $90 | $879,291 | $895,904 | $16,613 |
| $100 | $992,099 | $1,035,712 | $43,613 |
| $110 | $1,104,906 | $1,175,520 | $70,613 |
| $120 | $1,217,714 | $1,315,328 | $97,614 |




*The data represented here is believed to be accurate. Due to the projections of future results, please consult your tax advisor for further explanation.*

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According to this graph, the exercise-and-hold strategy, despite the associated costs, became more profitable for this employee when WorldCom's stock price exceeded roughly $85 per share.

Following the graph, Applicants attached an "assumptions page" that reflected the employee-specific data used to create the graph, including: the number of WorldCom options available to the employee and the grant prices of each; the available interest rate on the margin loan; the applicable taxes (state and federal) that would be assessed; and the price points used in the graph with the expected "gain" for the employee at each price point, based on the grant prices of the employee's options.[18]

The record contains several Options Analyses that Applicants sent to WorldCom employees, from March 29, 1999, to April 17, 2000. In his hearing testimony, Spartis admitted distributing, or causing the distribution of, "somewhere near 100" Options Analyses to his customers during the period at issue. Elias testified that she could not recall the exact number of Options Analyses she had sent out, but she admitted instructing the interns/sales assistants to transmit them to her customers, during the period at issue, on her behalf.

**3. Omissions in the Options Analysis**

The Exchange alleged that the Options Analysis omitted material facts or was misleading by "fail[ing] to depict any downside risk of holding the shares on margin," including "the velocity or magnitude of potential losses if the stock's price were to decline," and "by omitting the negative result if either the broker or the customer turned out to be wrong about the direction of WorldCom stock."

The Options Analysis failed to illustrate the effect on a customer's return in the event the market for WorldCom stock failed to appreciate or declined. The graph, as its focal point, showed that, if the stock price reached the uppermost price point, the employee would earn significantly higher returns, under the exercise-and-hold strategy, than if the employee followed an exercise-and-sell strategy. The Options Analysis did not provide a corresponding downward-sloping graph, reflecting a decreasing market in WorldCom stock. While the cover page contained some explanation of the assumptions used to calculate the customer's gain under the strategies – *e.g.*, that it assumed that future price of the stock "would be higher than the current market value" and that margin would be used to "minimize the use of cash" – nowhere in the Options Analysis was there a discussion of risk, including the risk associated with the customers' use of margin if WorldCom's stock price decreased, as ultimately occurred.

Applicants acknowledged in their testimony that the Options Analysis did not generally include any downward price analysis or discuss the risks involved. They maintained that, because a customer would do an exercise-and-hold transaction only if he or she thought the price of the stock would rise, it was pointless to provide the customer with an Options Analysis based on a declining market. Elias acknowledged that the customers were "true believers" in WorldCom. She testified that, while Applicants were capable of creating a downside depiction, "it would have been ridiculous to even waste the paper to print it out on. If the client thought the stock was going down, they wouldn't even want to look at it." Spartis testified similarly, asserting that the customers were sophisticated investors, "all aware that the stock could go

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18 The calculations underlying the graph were featured in several spreadsheets that were also attached, showing the associated costs.

down," and that the risks associated with holding stock were disclosed in the Firm's introductory packet and discussed during their "conversations" with customers.[19]

With respect to the price projections used in the Options Analysis, Applicants testified that they were not their own projections of WorldCom's stock price, but were based either on the customer's estimation or, more often, on the forecasts of Smith Barney's research analysts. As Spartis explained, because he was not an analyst, he "used the Firm's research and price targets," reported primarily by Firm analyst Jack Grubman, during the period at issue.[20]

**4. Management's Role**

Applicants testified that they believed the Options Analysis they used with customers was approved for distribution by their branch supervisors. Spartis testified that, in late 1998 or early 1999, he showed a template of the document to Michael Grace, the Atlanta Branch Manager and Applicants' supervisor during the period at issue. According to Spartis, Grace "approved" the use of the template after adding "disclaimers" and "two minor modifications."[21] Applicants also pointed to evidence, including notations in the ACC Group's database, indicating that several "supervisory designees," who were responsible for reviewing the Atlanta Branch's outgoing facsimile and mail correspondence, had reviewed some of the Options Analyses sent to customers during the period at issue.[22]

Grace's testimony, however, conflicted with Applicants' recollection. According to Grace, Spartis showed him a "rough draft" of the Options Analysis and, in response, Grace instructed Spartis to send the document to the Firm's compliance department in New York for review because it was "complicated correspondence" with numerous "moving parts" and it would be sent to more than one customer. Grace testified that Spartis responded that he would continue

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19 Although Spartis testified that two Options Analyses (of more than one hundred that Applicants transmitted) illustrated a decreasing market in WorldCom stock, his testimony is not corroborated by the record – including the testimony of the customers who purportedly received them and that of other financial consultants in the ACC Group. *See infra* note 24.

20 *See supra* note 5 and accompanying text. For example, the $130 stock price projected by Grubman throughout 1999 was reflected as the highest price point on several customers' Options Analyses in the record.

21 The document was already in use when Elias joined the ACC Group in 1999.

22 The ACC Group's intern, however, testified that "well over the majority" of time the documents were sent via e-mail. For much of the period at issue, the ACC Group's e-mail system was largely unmonitored by the Firm, until June 2001, when it began requiring the group to use the firmwide system.

working on the document and return to him with a revised version, but Spartis never did so. Grace stated that he only became aware that the document was being used in late 2000, when he received a customer complaint that attached the Options Analysis the customer had received.[23]

**5. Customer Testimony**

Several customers testified at the hearing that the Options Analysis they received presented an unbalanced picture of the two strategies and did not effectively explain the downside risks involved. Travis Brown, a customer of both Applicants, began discussing options strategies with Spartis in summer 1999 because he was leaving WorldCom and soon faced an accelerated vesting period for the exercise of his options. Brown testified that Applicants "gave extensive advice" "as to how to exercise" his options during "phone conversations and in written materials" and that Applicants told him that "the smart thing to do was to exercise and hold all of the options available to me on margin." According to Brown, the Options Analyses that Applicants sent to him during his discussions helped convince him that the exercise-and-hold strategy was the "smart way to proceed." Brown viewed the document's graph, in particular, as reflecting "that the opportunity was on the right side of the crossover point, and the downside risk was on the left side of the crossover point, which as you can see the right side far outweighs the left side in th[e] depiction."

When Brown decided to exercise his options and hold the resulting WorldCom shares, he funded the transaction with a $2.8 million margin loan. He testified that, although he had a "general understanding" of margin at the time, he did not understand, either from his discussions with Applicants or from the Options Analysis, the "accelerating" effect his margin loan would have on his losses if WorldCom's stock price declined. In late 2000, when the stock price plummeted, he sold off much of his account to cover margin calls, before eventually transferring his account to another broker-dealer.

Elizabeth Rich, an employee of WorldCom for over twenty years, initially contacted Applicants based on the recommendation of a co-worker. Rich testified that her decision on August 5, 1999, to exercise her options and hold WorldCom stock was based on "the [Options] analysis that Mr. Spartis sent me and the conversations that I had with him . . . reassuring me that [Applicants] knew how to handle my account and handle this type of transaction and my money." Rich, recounting her decision, testified, "I looked at the [Options] Analysis. I discussed it with my husband. We did not see any downside in the analysis. And that's what our decision was

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[23] In October 2003, Grace consented to a censure and three-month suspension with the Exchange for failing, among other things, to supervise reasonably the ACC Group's activities. The Firm, in the same proceeding, consented to a censure and $1 million fine for failing to ensure effective supervision.

based on."[24] In September 27, 2000, after experiencing heavy losses in her account and several margin calls due to concentrated positions of WorldCom stock, Rich was among the first customers to complain to the Firm about the exercise-and-hold strategy that Applicants had recommended to her. At the time, she complained: "At no point in the last thirteen months was there ever a single discussion about how to handle [this] account . . . if the market or the stock trended downward."[25]

## D. NYSE's Proceedings

On August 14, 2009, an NYSE Hearing Panel found that Applicants caused an NYSE Rule 472.30 violation by sending Option Analyses to customers that omitted material facts or were otherwise misleading.[26] The Panel found "the omission of any downward price analysis" in the Options Analysis materially misled customers because it "assum[ed] that the price of WorldCom stock would only go up[,] present[ing] an unduly optimistic picture of the potential gains that would result from exercising WorldCom options on margin and holding the resulting shares for at least one year." According to the Panel, "[b]ecause the use of margin ensured that customers would incur accelerated losses including interest payments and margin calls should the

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[24] The record contains an undated Options Analysis for Rich, illustrating a declining market for WorldCom stock (showing a drop in price from $53.88 to $24); however, there is no evidence Rich ever received it. Rich had no recollection of ever reviewing a downside Options Analysis. Elias, whose name appeared on the document, testified that she did not have one prepared that reflected a declining price – which was consistent with her other testimony that it would have been "ridiculous" to do so. When showed the graph at the hearing, Rich testified that she would have wanted to have received it "at the same time as I got the other analysis because then I could have seen exactly what would happen in either direction and make my decision from there as to whether or not I wanted to exercise and hold stock options." Although Spartis testified that a downside Options Analysis was also prepared for Brown, no such document is in the record nor does Brown's testimony support the claim. A fellow financial consultant of Applicants testified that he never saw a downward-trending Analysis used in the office.

[25] Another customer of Applicants who had followed the exercise-and-hold strategy testified that, if she had known about the potential magnitude of losses to be incurred if the stock price declined, she "never would have used margin" to fund her options transaction. The customer owed $489,000 in margin debt when she decided to transfer her account to another brokerage firm.

[26] The proceedings below lasted six years, having been instituted in 2003. The length of NYSE's proceedings appears to have been a result of scheduling conflicts, numerous issues involved, and a voluminous record, comprising 30 volumes that includes over 5,500 pages of hearing transcript and 200 exhibits. The Panel dismissed three of NYSE's charges against Applicants – that they made unsuitable recommendations, sent unapproved communications, and (with respect to Spartis alone) operated an unapproved and unsupervised e-mail system.

stock price decline, . . . the Analysis could not present an accurate and balanced comparison of the exercise strategies absent a discussion of those risks." The Panel, nonetheless, did not find that Applicants acted with scienter, "credit[ing their] contention that they were not attempting to circumvent [NYSE] rules . . . in sending customers [the Options Analysis]." The Panel censured Applicants, suspended Spartis for five months as the "architect" of the Options Analysis, and suspended Elias for three months.

On June 10, 2010, the NYSE Board of Directors affirmed the Panel's findings of liability[27] but modified its sanctions by vacating the suspensions. The Board sustained the censures the Panel had imposed.

## III.

NYSE Rule 472.30 prohibits, in relevant part, the use of "any communication which contains . . . any untrue statement or omission of a material fact or is otherwise misleading." An omitted fact is material if there is a substantial likelihood that a reasonable investor would have considered the omitted fact important to his or her investment decision, and disclosure of the omitted fact would have "significantly altered the 'total mix' of information available."[28]

We agree with the Exchange that Applicants caused the Firm's violation of Rule 472.30 by transmitting the Options Analysis to their customers. As the Exchange found, the Options Analysis materially misled customers by "present[ing] an unduly optimistic picture of the potential gains" that would result under the exercise-and-hold strategy and by failing to include any downside risk analysis. Rather than presenting "in a balanced way the risks and rewards of" two options strategies available to their customers, the Options Analysis improperly focused exclusively on the advantages of the exercise-and-hold strategy.[29] The document's upwardly

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[27] The Board, while adopting the Panel's liability findings, expressly disagreed with the Panel's analysis on one point of law – where it relied on case law under the antifraud statutes of the securities laws to reject Applicants' claim that NYSE Rule 472.30 required proof of customer reliance. The Board held that "there is simply no requirement [under Rule 472.30] that [NYSE] Enforcement prove customer reliance."

[28] *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

[29] *Jay Michael Fertman*, 51 S.E.C. 943, 950 (1994) (finding that salesman caused firm's distribution of misleading sales literature in violation of NASD rules); *see also Pac. On-Line Trading & Sec., Inc.*, 56 S.E.C. 1111, 1119 (2003) (finding that firm's advertisement violated NASD's public communications rule because it "highlighted the purported benefits of . . . [a] securities trading [program] but failed to provide essential risk disclosures regarding such trading").

(continued...)

trending graph, in particular, was visually misleading to customers, conveying the false impression that the exercise-and-hold strategy held only upside potential.[30] A corresponding downwardly trending graph would have significantly altered the total mix of information available to customers.[31]

We are further troubled by the omission of information from the Options Analysis regarding the potential adverse consequences of financing these transactions on margin. As we have previously emphasized, "[t]ransactions effected on margin . . . entail substantial risks."[32] When the price of the stock purchased on margin depreciates sufficiently, as occurred here, customers may be forced to sell securities from their accounts at a loss to cover margin calls, in addition to paying interest on the margin debt they used to fund the transaction.[33] Customers

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(...continued)

In addition to NYSE Rule 472, Firm policies required that communications with the public "not contain any statements which are untrue or omit a material fact or are otherwise false or misleading" and present "a balance between describing the risks and the potential rewards of any investment."

30 *See, e.g., Valicenti Advisory Servs., Inc.*, 53 S.E.C. 1033, 1039 (1998) (finding advertising "[c]hart and [b]ar [g]raph" that adviser distributed to his customers "presented a false portrayal of [his firm's] past performance and a misleading comparison . . . with the performance of other money managers"), *aff'd*, 198 F.3d 62 (2d Cir. 1999).

31 Customer testimony supports this conclusion. For example, Rich testified that a decreasing stock depiction would have shown "exactly what would happen in either direction [enabling me to] make my decision from there as to whether or not I wanted to exercise and hold stock options."

32 *Eugene J. Erdos*, 47 S.E.C. 985, 986 n.5 (1983), *aff'd*, 742 F.2d 507 (9th Cir. 1984).

33 *See, e.g., Laurie Jones Canady*, 54 S.E.C. 65, 80 n.27 (1999) ("'Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently, giving rise to a margin call in the account. Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain.'" (quoting *Stephen Thorleif Rangen*, 52 S.E.C. 1304, 1307-08 (1997)), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000).

testified that information about the risks associated with margin was material to them.[34] To this point, it is important to recognize that customers, known to Applicants as WorldCom "true believers," were extremely enthusiastic about WorldCom's prospects, in part, because of the highly upbeat assessments by Smith Barney's own research analyst.

Applicants do not deny transmitting the Options Analysis to their customers, but they nevertheless contend that they should not be held liable because it was "reviewed and approved by" their supervisors. Applicants claim that "the Branch's supervisory personnel were either satisfied that the content of the Analysis was 'reasonable' and did not contain misrepresentations or omissions, or failed to use their ample resources to fulfill" their supervisory responsibilities. "Either way," according to Applicants, they "had a reasonable basis to assume that the Options Analysis conformed . . . with the requirements of [NYSE] Rule 472.30 . . . and could be distributed to clients."

We disagree. While the record contains some evidence that certain supervisory designees (who did not testify) were aware that the Options Analysis was being sent to customers by their review of facsimile and mail correspondence, we do not find the evidence conclusive that the document was ever approved by Firm management or that Applicants had a reasonable basis for believing so.[35] Although Spartis claimed his branch manager, Grace, was involved in reviewing a template of the document, Grace testified that he only saw a "rough draft" and had specifically directed Spartis to send a copy to the Firm's compliance department for approval and return a revised document to him, which Spartis never did. Grace denied knowing the document was in use until receiving complaints in late 2000.[36] In any event, even if there was supervisory approval, it is well established that the duties owed by a securities professional to his or her customer are not "abridged by a failure on the part of his [or her] supervisors."[37] As we have held, a "broker has responsibility for his own or her own actions and cannot blame others for [his

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[34] For example, Brown testified that the Options Analysis did not alert him to the accelerated losses he would incur by holding concentrated positions of WorldCom stock on margin. Other customers concurred, testifying that they were unaware of the effects margin would have on their losses.

[35] As noted, *supra* note 22, the majority of Options Analyses were transmitted to customers through an unmonitored e-mail system.

[36] The Exchange's Hearing Panel dismissed a separate charge that Applicants sent unapproved correspondence during the period at issue. *See supra* note 26. In determining to dismiss, the Panel, noting "contradictory testimony," found that "the [Options] Analysis was tacitly if not expressly approved by supervisory personnel," based on the personnel's review of outgoing facsimile and mail correspondence.

[37] *Donald T. Sheldon*, 51 S.E.C. 59, 88 n.130 (1992), *aff'd*, 45 F.3d 1515 (11th Cir. 1995).

or her] own failings."[38] Applicants thus were obligated to comply with regulatory requirements regardless of the actions of others at the Firm.[39]

Applicants further contend that the Options Analysis did not contain an omission of material fact nor was it misleading. According to Applicants, the Options Analysis "was not a recommendation" to customers but "merely a comparison of the tax consequences" under two options strategies and did not show the consequences of a decreasing stock price "because, by definition, there would be no tax savings" and the exercise-and-hold strategy "could not be more profitable." They claim the consequences of a stock price decrease were known to customers, as the Options Analysis expressly disclaimed that, "[o]f course, the most important factor . . . is that the future market value" of the stock "is higher." They assert that the risks of the exercise-and-hold strategy were discussed in the Firm's introductory materials to new customers and during their phone conversations, citing Brown's testimony as support.

We reject Applicants' position that the potential adverse consequences of a flat or declining market for WorldCom's stock were so obvious that they need not be disclosed in the document. As discussed, the Options Analysis materially misled customers by presenting a one-sided picture of the customer's earnings potential under the exercise-and-hold strategy and by omitting important risk disclosures. Given the one-sided disclosure that was made to each customer concerning the customer's earning potential, "'[a] reasonable investor would want to know of any risks or potential harms associated with his or her investment.'"[40]

While Applicants attempt to lessen the importance of these disclosures by characterizing the Options Analysis as a mere "comparison," not a "recommendation," such a distinction is irrelevant for purposes of NYSE Rule 472.30. As mentioned, the Rule covers "any communication" with the public and, thus, applies here regardless of how Applicants seek to characterize the Options Analysis.[41]

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[38] *Justine Susan Fischer*, 53 S.E.C. 734, 741 n.4 (1998); *see also Larry Ira Klein*, 52 S.E.C. 1030, 1034-35 (1993) (rejecting salesman's "attempt to shift responsibility" to his firm and finding that, "as a registered securities professional and the author of the list, he is responsible for its contents").

[39] *See, e.g., Adrian C. Havill*, 53 S.E.C. 1060, 1068 (1998) (rejecting applicant's defense against fraud allegations that he relied on supervisor's guidance regarding suspicious trades) (collecting cases).

[40] *Donner Corp. Int'l*, Exchange Act Rel. No 55313 (Feb. 20, 2007), 90 SEC Docket 11, 26 & n.46 (quoting *SEC v Treadway*, 430 F. Supp. 2d 293, 330 (S.D.N.Y. 2006)).

[41] A "communication," under NYSE Rule 472.10, is broadly defined "to include, but is not limited to advertisements, market letters, research reports, sales literature, electronic

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We also do not view the vague "boilerplate" disclaimers included in the Options Analysis as adequately addressing the misleading aspects of the document.[42] Because the Options Analysis provided specific information tailored to the individual customer's particular situation regarding his or her potential return under the two strategies, it should have included similarly specific information regarding the potential downside of those strategies.

The generic risk disclosures included in the introductory materials and during their telephone conversations also did not sufficiently put customers on notice of the losses they could incur if the stock price remained flat or decreased. The Options Analysis itself should have alerted a customer to the specific risks involved in the customer's particular situation and not depended on scattered information available to the customer.[43] Indeed, despite Applicants' current reliance on these earlier disclosures, the Options Analysis itself neither referred back to them nor gave any indication of risk. The introductory materials, in any event, only generally referred to the "market risk" of holding stock and using margin. Nor does Brown's testimony (or any of the telephone conversations in evidence) support Applicants' claim that the risks were adequately discussed. As Brown testified, the conversations and materials gave him only a "general understanding" of margin, but in no way prepared him for the "accelerated" losses he would incur in his account due to the use of margin.

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(...continued)
communication, communications in and with the press and wires and memoranda to branch offices or correspondent firms which are shown or distributed to customers or the public."

[42] *See, e.g., Brian Pendergast*, 55 S.E.C. 289, 301 & n.15 (2001) ("generic disclaimer that 'markets are unpredictable' failed to cure specific misleading aspects of" offering memorandum) (citing *Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-72 (3d Cir. 1993) ("vague (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate"); *see also Kenneth R. Ward*, 56 S.E.C. 236, 259 n.47 (2003) ("'boilerplate' disclaimers in no way overrode Ward's unqualified recommendations regarding specific securities"), *aff'd*, 75 Fed. App'x 320 (5th Cir. 2003) (unpublished).

[43] *See, e.g., Pac On-Line*, 56 S.E.C. at 1120 ("disclaimers of the risks of online trading provided to customers at . . . seminars and when . . . customers opened new accounts" failed to cure firm's misleading advertisement because "[a]dvertisements must stand on their own" under NASD's public communications rule); *Donner Corp.*, 90 SEC Docket at 25-26 ("The research reports themselves needed to convey a complete and accurate picture and could not depend on information available to investors."); *Klein*, 52 S.E.C. at 1036 ("[D]eliver[y of] a prospectus to [an investor] that disclosed risks of investing . . . does not excuse his failure to inform her fully of the risks of the investment package he proposed."); *see also Richmark Capital Corp.*, 57 S.E.C. 1, 15 & n.26 (2003) ("A broker may not satisfy [full disclosure obligation] by pointing to bits and pieces of information that appeared . . . elsewhere and were never brought to the customer's attention.") (collecting cases), *aff'd*, 86 Fed. App'x 744 (5th Cir. 2004) (unpublished).

Applicants also contend that they cannot be held liable because they "did not act with scienter" – *i.e.*, "a mental state embracing intent to deceive, manipulate, or defraud"[44] – which they claim is a required element of NYSE Rule 472.30. For support, Applicants principally rely on *SEC v. Johnson*,[45] an unpublished district court decision in which the court observed that Rule 472.30 "mirrors § 10(b) and Rule 10b-5" of the Securities Exchange Act of 1934. Applicants argue that, because those antifraud provisions contain a scienter requirement, Rule 472.30 must also be construed as containing such a requirement.

In finding Applicants liable, the Exchange interpreted Rule 472.30 broadly, construing it as applying to any misleading communication by an Exchange member to the public, regardless of the member's state of mind. In our view, a plain reading of the Rule supports the Exchange's interpretation.[46] Rule 472.30 is very broadly worded, proscribing the "utilization of any communication which contains . . . any untrue statement or omission of a material fact or is otherwise misleading." Nowhere in the language of the Rule is there an indication that scienter is required. For instance, absent are "the words 'manipulative,' device' and 'contrivance'" that the Supreme Court held in *Ernst & Ernst v. Hochfelder* connote a state-of-mind requirement under the federal securities laws.[47] Nor have Applicants pointed to any evidence in the Rule's regulatory history (nor have we found any) that limits the Rule's application to only fraudulent

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[44] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[45] Fed. Sec. L. Rep. ¶ 93,205, 2005 WL 696891, at *5 (S.D.N.Y. 2005).

[46] In this connection, we note that the Exchange's official rule interpretation guide indicates that the Rule should be broadly construed. NYSE Interpretation Handbook No. 92-5 (1992) (noting that Rule 472.30 applies to any "untruthful, misleading, or inaccurate statements in any form of communication with customers or the public").

[47] *Hochfelder*, 425 U.S. at 197-201 (holding that violations of Exchange Act § 10(b) and Rule 10b-5 require scienter based on the presence of such terms and noting that "ascertainment of . . . intent with respect to the standard of liability created by a particular section . . . rest[s] primarily on the language of that section"). Similarly absent from Rule 472.30's language is any requirement that the "member know or has reason to know" the communication is misleading. *Cf.* NASD Rule 2210(d)(1)(B) (proscribing use of "any public communication that the member *knows or has reason to know* contains any untrue statement of material fact or is otherwise false or misleading" (emphasis added)).

communications. In agreeing with the Exchange, we further note that self-regulatory organizations are accorded "some level of deference"[48] in interpreting and applying their rules.[49]

The *Johnson* decision does not alter our conclusion. At issue in that case was whether a research analyst at a NYSE member firm violated the antifraud provisions of the federal securities laws, not Rule 472.30. The complaint alleged that Johnson violated Exchange Act Section 10(b), Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933, by failing to disclose his financial interest in companies that he covered as an analyst. Johnson challenged the allegations, claiming he was "under no duty to disclose" the information. In rejecting his claim, the court referenced Rule 472.30, by analogy, to underscore the industry standard applicable to him that a "philosophy of full disclosure should pervade a member's communications with the public."[50] Contrary to Applicants' contentions, the court did not render any opinion as to whether NYSE Rule 472.30 requires scienter.[51]

Although we acknowledge some similarities in wording between Rule 472.30 and subsection (b) of Exchange Act Rule 10b-5 (as *Johnson* observed),[52] our reading of Supreme

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48 *Heath v. SEC*, 586 F.3d 122, 139 (2d Cir. 2009) (citing *Shulz v. SEC*, 614 F.2d 561, 571 (7th Cir. 1980) ("[B]ecause these are rules of the Exchange, the Exchange should be allowed broad discretion in determining their meaning.").

49 Although we need not address Applicants' motive or whether they acted with scienter, we note that the evidence indicates that Applicants' objective of establishing long-term brokerage relationships with these customers was furthered by the exercise-and-hold strategy, which required customers to establish brokerage accounts; the exercise-and-sell strategy did not require customers to set up Smith Barney accounts.

50 *Johnson*, 2005 WL 696891, at *5.

51 Applicants further argue that liability under Rule 472.30 requires evidence of scienter because the definition of materiality used by the Exchange in interpreting that aspect of the Rule was found in a Supreme Court decision, *Basic Inc. v. Levinson,* which applied a scienter-based antifraud provision. 485 U.S. at 231-32, 242. However, we find no basis to support Applicants' position that the materiality definition in *Basic* cannot be severed from the remainder of its analysis. The *Basic* definition of materiality is the "general test for determining whether a fact is material under the federal securities laws," irrespective of the mental state involved. *Media Gen. Inc. v. Tomlin*, 387 F.3d 865, 869 (D.C. Cir. 2004); *see also Oxford Asset Mgmt., Ltd. v. Jaharis*, 297 F.3d 1182, 1189 (11th Cir. 2002) (applying *Basic* definition to non-scienter-based violation and noting its "test of materiality is well known").

52 *Compare* NYSE Rule 472.30 (prohibiting use of a communication containing "any untrue statement or omission of a material fact or is otherwise misleading"), *with* 17 C.F.R.

(continued...)

Court precedent interpreting this language does not support Applicants' position. In *Hochfelder*, the Court determined that it was not the express language contained in Rule 10b-5 that required a showing of scienter – noting, in fact, that "viewed in isolation the language of subsection (b) . . . could be read as proscribing . . . any type of material misstatement or omission."[53] The Court, nonetheless, held that scienter was required under the entirety of Rule 10b-5 because the rule was adopted pursuant to a statute, Exchange Act § 10(b), that required scienter.[54] Subsequently, in *Aaron v SEC*, the Court considered whether a similarly worded section of the Securities Act required scienter in the absence of legislative intent indicating scienter was required: the Court held that scienter was not required under Securities Act Section 17(a)(2) because "the language . . . prohibit[ing] any person from obtaining money or property 'by means of any untrue statement of a material fact or any omission to state a material fact,' is devoid of any suggestion whatsoever of a scienter requirement."[55] The language of Rule 472.30, as discussed, is even broader than these provisions and the Exchange has not otherwise indicated that a scienter requirement should be read into the express language of the Rule.[56]

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[52] (...continued)
§ 240.10b-5(b) (prohibiting the making of "any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading").

[53] 425 U.S. at 212.

[54] *Id.* 212-14 ("[D]espite the broad view of [Rule 10b-5] advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).").

[55] 446 U.S. 680, 696 (1980) (holding that neither Securities Act Section 17(a)(2) nor (a)(3) contains a scienter requirement).

[56] For similar reasons, we reject Applicants' reliance on common law fraud cases to assert that Rule 472.30 requires a showing that customers directly relied on the communication. We agree with the Exchange that the language of Rule 472.30 does not require a showing of customer reliance. *See supra* note 27.

**IV.**

The Exchange found that censures were warranted for both Applicants.[57] Although, as discussed above, Applicants challenge the Exchange's findings of violations, they make no separate argument regarding sanctions.

Under Exchange Act Section 19(e), we evaluate disciplinary sanctions to determine if, "having due regard for the public interest and the protection of investors," they are "excessive or oppressive."[58] Applying that standard, we sustain the Exchange's imposition of censures as amply warranted.[59]

NYSE Rule 472.30 serves an important policy objective by encouraging NYSE members and their associated persons to provide full and fair disclosure to their investors. The Rule, as we have previously stated, "promote[s] just and equitable principles of trade, prevent[s] fraudulent and manipulative acts, and, in general, protect[s] investors and the public interest."[60] Applicants' actions thwarted this policy objective by providing an unbalanced picture of the risks and rewards of the exercise-and-hold strategy. While the Options Analysis showed, with precision, the potential gains under the strategy if WorldCom's stock increased, it left the customers to guess as to their possible losses and the risks involved if the stock remained flat or declined. As the Exchange's Hearing Panel observed, "[t]he customers in question relied on [Applicants] to provide them with sound financial advice regarding the largest investment of their lives; they instead received information that omitted material facts and was misleading."

Under the circumstances, we find that the censures imposed by the Exchange are in the public interest and remedial. In doing so, we note a troubling failure by Applicants to accept responsibility for their actions, seeking to pass the blame to others – such as the Firm, their

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57 The Exchange vacated suspensions that had been imposed by the Hearing Panel, citing the "unique circumstances" of the case, as both Applicants had "left the securities industry in February 2002 and have been defending themselves from the same general nucleus of charges for approximately the last eight years."

58 We also evaluate sanctions to determine if they impose any unnecessary or inappropriate burden on competition. Applicants do not claim, nor does the record show, that the Exchange's sanctions impose such a burden.

59 We note that "Exchange Act Section 19(e)(2), 15 U.S.C. § 78s(e)(2), permits us to 'cancel, reduce, or require the remission of' a sanction imposed by a self-regulatory organization but does not permit us to increase the sanction." *Gregory W. Gray, Jr.*, Exchange Act Rel. No. 60361 (July 22, 2009), 96 SEC Docket 19038, 19055 n.41.

60 *Order Approving Proposed Rule Change*, Exchange Act Rel. No. 27819 (Mar. 19, 1990), 45 SEC Docket 1517, 1517.

supervisors, research analysts, and even their customers (*e.g.*, for providing them with the price projections used in the Options Analysis) – and ignoring Spartis's role in creating the document and Applicants' central role in disseminating it. Although Applicants are not currently working in the securities industry, the censures will serve to alert the public, including other self-regulatory organizations, of the unacceptability of Applicants' conduct.[61] The sanctions imposed will have the additional salutary effect of encouraging other member firms and their associated persons to communicate in a balanced way with their customers.

An appropriate order will issue.[62]

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

Elizabeth M. Murphy
Secretary

Jill M. Peterson

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

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[61] *See, e.g., Salvatore F. Sodano*, Order Reversing Initial Decision and Remanding for Further Proceedings, Exchange Act Rel. No. 59141 (Dec. 22, 2008), 94 SEC Docket 12714, 12719 (noting that censure can "serve the remedial purpose of alerting the public, including other SROs and their officers and directors, of the unacceptability of the conduct at issue").

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64489 / May 13, 2011

Admin. Proc. File No. 3-13979

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In the Matter of the Application of

PHILIP L. SPARTIS
and
AMY J. ELIAS
c/o Jeffrey L. Liddle, Esq.
Liddle & Robinson, L.L.P
800 Third Avenue
New York, New York 10022

For Review of Disciplinary Action Taken by

NYSE Regulation, Inc.

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ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES ASSOCIATION

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

ORDERED that the disciplinary action taken by NYSE Regulation, Inc., against Philip L. Spartis and Amy J. Elias, be, and it hereby is, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64486 / May 13, 2011

Admin. Proc. File No. 3-14016

In the Matter of

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

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY PROCEEDINGS

Failure to Provide Written Notice to Member Firm Employer Regarding Private Securities Transactions

Conduct Inconsistent with Just and Equitable Principles of Trade

Individual registered as a representative and principal of member firm of registered securities association participated in private securities transactions without providing prior written notice to his member-firm employer and, as a result, engaged in conduct inconsistent with just and equitable principles of trade. *Held*, association's findings of violation and the sanctions imposed are *sustained.*

APPEARANCES:

*Isaac M. Zucker*, of Law Offices of Isaac M. Zucker, PLLC, for Harry Friedman.

*Marc Menchel*, *Alan Lawhead*, and *Jante C. Turner*, for FINRA.

Appeal filed: August 19, 2010
Last brief received: November 29, 2010

I.

Harry Friedman, a general securities representative and a general securities principal formerly associated with former FINRA member firm First Montauk Securities Corp. ("First Montauk" or "the Firm"), appeals from FINRA disciplinary action against him.[1] FINRA found that Friedman engaged in private securities transactions without prior written notice to First Montauk, in violation of NASD Conduct Rules 3040 and 2110.[2] FINRA fined Friedman $77,500, suspended him in all capacities for nine months, and ordered that Friedman pay costs associated with the hearing and appeal. We base our findings on an independent review of the record.

II.

## A. Friedman's Association with First Montauk

Friedman has been a registered representative at several FINRA member firms since October 1994 and a registered securities principal since April 1996. In October 2002, Friedman registered as a representative and a securities principal with First Montauk. Friedman was the branch office manager for the Firm's Office of Supervisory Jurisdiction ("OSJ") in New York City and was responsible for regulatory compliance. Friedman is presently registered with another FINRA member firm, Prestige Financial Center, Inc.

In November 2002, Joseph Schnaier became a registered representative in the First Montauk OSJ. Friedman and Schnaier each owned fifty percent of an entity called Global

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[1] On July 26, 2007, we approved a proposed rule change filed by National Association of Securities Dealers, Inc. ("NASD") to amend NASD's Restated Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of NASD and certain member-regulation, enforcement, and arbitration functions of the New York Stock Exchange ("NYSE"). *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. Although the investigation into this matter was initiated before the consolidation, the complaint was filed afterwards. References to FINRA, therefore, include NASD actions.

[2] As part of the effort to consolidate and reorganize NASD's and NYSE's rules into one FINRA rulebook, NASD Rule 2110 (which was otherwise unchanged) was codified as FINRA Rule 2010, effective December 15, 2008. *See* FINRA Regulatory Notice 08-57 (Oct. 2008). NASD Rule 3040 has not been codified as a FINRA Rule. *See generally Kirlin Sec., Inc.*, Exchange Act Rel. No. 61135 (Dec. 10, 2009), 97 SEC Docket 23299, 23300 n.4 (describing rules consolidation). Because the conduct at issue here occurred before the consolidation, we will continue to refer to the NASD Rules.

NASD Conduct Rule 3040 prohibits involvement by a registered representative of a FINRA member firm in a private securities transaction outside the regular course or scope of employment without providing prior written notice to the member firm. NASD Conduct Rule 2110 requires members to observe high standards of commercial honor and just and equitable principles of trade.

International Services, LLC ("Global International"). The OSJ's revenues were deposited into Global International's bank account, and Global International paid all of the OSJ's expenses, including the salaries of Friedman and Schnaier.

## B. Friedman and Schnaier Are Introduced to Majesco and Purchase Majesco Shares

At the First Montauk OSJ, Friedman focused on management of the retail brokerage operations, and Schnaier's primary role was development of investment banking business for the Firm. In January 2003, Schnaier became acquainted with Majesco Sales, Inc. ("Majesco"), a private video game company that wanted to raise capital and eventually become a public company. Later in 2003, Friedman and Schnaier met with Majesco's management and toured Majesco's facilities, in an effort to gain Majesco's investment banking business for the Firm.

Although First Montauk did not ultimately provide investment banking services to Majesco, Friedman and Schnaier introduced Majesco management to individuals who provided assistance to the company in its efforts to complete a reverse merger.[3] In October 2003, ConnectivCorp, a public company, announced its intention to enter into a reverse merger with Majesco.

Before the companies completed the reverse merger, Majesco management offered Friedman and Schnaier the opportunity to invest in Majesco at a price of $0.01 per share. On November 27, 2003, Friedman and Schnaier each contributed $12,500 and, through Global International, purchased 2,500,000 shares of Majesco common stock for a total purchase price of $25,000. Friedman, Schnaier, and Global International did not provide First Montauk with prior written notice of this purchase.

On December 5, 2003, Majesco completed its reverse merger with ConnectivCorp, forming the publicly traded company called Majesco Holdings, Inc. ("Majesco Holdings"). Upon completion of the reverse merger, all Majesco shares converted, one-for-one, into shares of Majesco Holdings. On the day of the reverse merger, Majesco Holdings' stock opened at $1.01 per share and closed at $1.05 per share. During the first quarter of 2004, the price of Majesco Holdings' stock rose to more than $3.00 per share.

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3 A "reverse merger" is a method by which a private company arranges to be acquired by a public company with minimal assets through a merger of the companies, with the shell company surviving and the former shareholders of the private business controlling the surviving entity. *See Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies*, Securities Act Rel. No. 8587 (July 15, 2005), 85 SEC Docket 3698; *see also SEC v. Cavanagh*, 445 F.3d 105, 108 n.4 (2d Cir. 2006) (discussing mechanics of a reverse merger).

## C. Friedman and Schnaier Sell Almost Half of Their Majesco Holdings Securities

In April and May 2004, Friedman and Schnaier sold 1,175,000 of their Majesco Holdings shares to three different purchasers. Friedman and Schnaier sold these shares at a significant discount from the then-current market price of the shares. Among other things, the shares were subject to a lockup agreement that prohibited their re-sale until October 2005, one year after Majesco Holdings filed its initial registration statement. Friedman and Schnaier sold their Majesco Holdings shares as follows:

> (1) On April 15, 2004, Friedman and Schnaier sold 100,000 shares of Majesco Holdings, at a price of $1.25 per share, to Joel Gold. Gold was not a First Montauk customer. Friedman explained that, at the time of the transactions, Friedman and Schnaier had hoped that Gold might join them in a new broker-dealer firm they planned to start;
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> (2) On April 20, 2004, Friedman and Schnaier sold 75,000 shares of Majesco Holdings, at a price of $1.40 per share, to Regina Glick, a First Montauk customer and family friend of Friedman. Friedman initiated contact with Glick, and he set the price of the sales to Glick. Friedman testified that he offered the shares at a discount from the then-current market price in order to help Glick offset losses she had suffered in investments with a different broker-dealer;
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> (3) On May 24, 2004, Friedman and Schnaier sold 1,000,000 shares of Majesco Holdings, at a price of $1.25 per share, to Trinad Capital, a private investment company. Trinad Capital sought to purchase all 2,500,000 of Global International's Majesco Holdings shares at a price of $1.00 per share soon after the completion of the reverse merger. Although the proposed transaction to purchase all of Global International's shares did not occur, the two sides eventually agreed on the ultimate number of shares and purchase price.

Friedman and Schnaier, through Global International, retained the remaining 1,325,000 Majesco Holdings shares after these three sales.

Friedman, Schnaier, and Global International did not provide prior written notice to First Montauk of their sales of Majesco Holdings shares to Gold, Glick, and Trinad Capital. Friedman and Schnaier together netted approximately $1,470,000 from these sales. After using the proceeds to pay Global International's expenses, Friedman and Schnaier split the remaining profits equally. Friedman's personal net profit from the sales was approximately $550,000.

## D. Procedural History

FINRA discovered Friedman's and Schnaier's sales of Majesco Holdings securities in November 2004, when FINRA examiners interviewed them in connection with their application to register a new firm as a broker-dealer. The examiners noticed two substantial deposits in Friedman's and Schnaier's bank accounts, and Friedman explained that the sales of Majesco Holdings securities were the source of those deposits. When FINRA examiners asked whether they had reported the sales to First Montauk, Friedman stated that he did not realize he was obligated to do so, and Schnaier said nothing. After the interview, the FINRA examiners requested additional information about the sales from Friedman and Schnaier. Friedman and Schnaier provided a written response to a series of questions posed by the FINRA examiners, in which they acknowledged that they had not notified First Montauk of either the purchase or the subsequent sales of the shares. Friedman and Schnaier withdrew their broker-dealer registration application in February 2005.

On April 18 and 23, 2007, FINRA Enforcement conducted on-the-record interviews with Friedman and Schnaier, respectively, in connection with an investigation of the Majesco transactions. Friedman testified consistently with his responses to the FINRA examiners in 2004 and 2005 that, at the time of the Majesco transactions, he did not believe that he was obligated to disclose the transactions to First Montauk because he considered the investment to be passive. He also testified that he did not discuss with Schnaier whether the transactions should be disclosed at that time because of "[his] belief that no disclosure was necessary because of the type of transaction." Friedman further testified that, once he and Schnaier received FINRA's requests to appear for the on-the-record interviews, he discussed the transactions with Schnaier, and only then did Schnaier tell Friedman that Schnaier had allegedly provided written and oral notice to Herbert Kurinsky, First Montauk's President.[4]

On November 14, 2007, FINRA Enforcement filed a complaint against Friedman and Schnaier, alleging that their initial purchases of Majesco and subsequent sales of Majesco Holdings securities violated NASD Conduct Rules 3040 and 2110. Before a FINRA Hearing Panel, Schnaier testified that he had provided oral and written notice of the purchases and sales to Kurinsky. Neither Friedman nor Schnaier produced copies of any written notice to First Montauk of the transactions, claiming that such documents may have been lost or destroyed in a flood at the OSJ's offices. The Hearing Panel found that Schnaier's testimony was not credible and, as a result, that Friedman and Schnaier violated Rule 3040. The Hearing Panel suspended Friedman in all capacities for forty-five days and imposed a $77,500 fine.[5]

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4 In his April 2007 on-the-record testimony, Schnaier claimed that he was previously unaware of the earlier written response to FINRA examiners, which stated that there had been no disclosure of the transactions to First Montauk. Schnaier testified that he dealt with the "corporate finance side of the business" and had nothing to do with matters such as responding to FINRA examiners' questions in connection with the broker-dealer registration application, which was Friedman's responsibility at the OSJ.

5 The FINRA Hearing Panel found that Schnaier, like Friedman, violated Rules 3040 and 2110, and the Hearing Panel fined Schnaier $77,500 and suspended him for ninety days. Schnaier did not appeal the Hearing Panel's decision to the National Adjudicatory Council. FINRA Enforcement (continued...)

FINRA appealed the Hearing Panel's determination of sanctions to FINRA's National Adjudicatory Council ("NAC"), seeking a longer suspension. Friedman cross-appealed, claiming that he did not commit the alleged violations and arguing that, even if he had committed the violations, the suspension was unnecessarily lengthy.

On July 26, 2010, the NAC affirmed the Hearing Panel's findings of violations and the $77,500 fine. The NAC found that Friedman's violations were "very serious," and it increased the suspension imposed by the Hearing Panel from forty-five days to nine months. This appeal followed.

## III.

Exchange Act Section 19(e) provides that, in reviewing a disciplinary proceeding by a self-regulatory organization ("SRO"), we shall determine whether the associated person engaged in the conduct found by the SRO, whether the conduct violated the SRO rules at issue, and whether those rules were applied in a manner consistent with the purposes of the Exchange Act.[6] In conducting our review, we apply a preponderance of the evidence standard to determine whether the record supports FINRA's findings that Friedman's conduct violated FINRA's Rules.[7]

NASD Conduct Rule 3040 provides that "[n]o person associated with a member shall participate in any manner in a private securities transaction" unless he or she provides prior written notice to the member. A "private securities transaction" is defined as "any securities transaction outside the regular course or scope of an associated person's employment with a member."

Friedman concedes that the transactions at issue "involved the purchase and sale of shares in a private company ('Majesco') by Respondent Friedman." Friedman acknowledges that he paid $12,500 for his Majesco shares and subsequently sold a portion of those shares to Gold, Glick, and Trinad Capital. He also admits that he solicited his First Montauk customer, Glick, and established the $1.40 per share price at which she bought the Majesco Holdings shares from Friedman and Schnaier. As an initial matter, our cases have consistently affirmed a broad

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[5] (...continued)
initially appealed Schnaier's ninety-day suspension, but subsequently withdrew its appeal after Schnaier agreed to a bar in a separate disciplinary action.

[6] 15 U.S.C. § 78s(e).

[7] *See Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in NASD disciplinary proceeding).

interpretation of Rule 3040 and its operative phrase, "participate in any manner."[8] We find that Friedman's initial purchase of Majesco shares and three subsequent sales of Majesco Holdings shares constitute "participat[ion] in any manner in private securities transactions" under Rule 3040.

We reject Friedman's argument that Schnaier, not Friedman, was responsible for disclosing the transactions to First Montauk because he "was the individual through whom all relevant conversations with Majesco occurred" and because Schnaier "concentrat[ed] upon investment banking, of which Respondent Friedman was largely unaware." Regardless of whether Friedman and Schnaier initially sought Majesco's investment banking business for the Firm, the transactions at issue constitute private securities transactions by Friedman under Rule 3040.

Friedman also argues, contrary to his earlier answers to FINRA examiners in connection with the broker-dealer application, his on-the-record interview in connection with FINRA's investigation of the conduct at issue here, and his testimony at the hearing, that when he decided not to disclose the transactions to First Montauk, he believed that Schnaier had provided oral and written notice of the transactions to First Montauk. Friedman cites Schnaier's testimony "that **he** [*i.e.*, Schnaier] had numerous conversations with the President of First Montauk, Herbert Kurinsky, in which permission was sought and given for Mr. Schnaier and Respondent Friedman to engage in the Majesco transactions."[9] Even if Schnaier had disclosed the transactions in conversations with Kurinsky, this would not satisfy Schnaier's Rule 3040 reporting obligation. The Rule states that an associated person "shall provide written notice," not oral notice, to the FINRA member firm with which he or she is associated before engaging in a private securities transaction.[10]

In any event, the Hearing Panel did not credit Schnaier's testimony that he had provided written notice to Kurinsky disclosing the transactions, or that he had provided either oral or written notice to First Montauk. While a First Montauk vice president testified that Schnaier had received approval from a First Montauk regional supervisor, the Hearing Panel concluded that the vice president was a friend of Friedman and Schnaier, advocated on their behalf, and was therefore not credible as a witness. The Hearing Panel also found that Kurinsky, who Schnaier testified approved the transactions, was suffering from memory problems and was therefore unable to remember specific events and people, which made him an unreliable witness as to his interactions with Friedman and Schnaier. We have consistently held that "credibility

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[8] *See, e.g.*, *Joseph Abbondante*, 58 S.E.C. 1082, 1098 (2006) (noting that "Conduct Rule 3040 is broad in scope"), *aff'd*, 209 Fed. Appx. 6 (2d Cir. 2006); *Mark H. Love*, 57 S.E.C. 315, 319 (2004) (emphasizing that the phrase "participates in any manner" "should be read broadly"); *Stephen J. Gluckman*, 54 S.E.C. 175, 182-83 (1999) (stating that "[t]he reach of Conduct Rule 3040 is very broad").

[9] Emphasis in Friedman's brief.

[10] *See Joseph J. Vastano*, 57 S.E.C. 803, 811 (2004).

determinations of an initial fact finder are entitled to considerable weight because they are based on hearing the witnesses' testimony and observing their demeanor."[11] We find no basis to overturn FINRA's credibility determinations here.

In addition, evidence in the record corroborates the Hearing Panel's credibility determinations. Although Schnaier testified that he had provided written notice of the transactions to First Montauk, there is no evidence of such written notice in the record, and Friedman testified that he never saw any written notice. Several First Montauk registered representatives testified at the hearing that approvals for private securities transactions did not come directly from Kurinsky, as Schnaier's testimony suggested, but typically from the compliance department. Furthermore, Friedman and Schnaier never mentioned the existence of any written notice during FINRA's review of their broker-dealer registration application, when FINRA examiners made clear that whether or not Friedman and Schnaier had provided written notice of the transactions would be a key determinant of whether the registration request would be granted.

Further, even if Friedman had, contrary to his earlier testimony, relied on a belief that Schnaier had provided written disclosure of the transactions to First Montauk, any written disclosure by Schnaier would not be sufficient. Rule 3040 applies to all registered persons associated with FINRA member firms and requires each person who participates in a private securities transaction to provide prior written notice to his or her member firm.[12] Thus, Friedman had an independent obligation to provide First Montauk prior written notice of his private securities transactions. Schnaier's investment banking responsibility at the OSJ and his alleged oral and written disclosure of the transactions to First Montauk are irrelevant to Friedman's obligation to disclose the transactions to First Montauk.

Friedman also claims that he was not aware that he was required to report the transactions pursuant to Rule 3040. Instead, he asserts that he believed that NASD Conduct Rule 3030,[13] which was in effect at the time of the violations and required registered representatives to provide written disclosure of their outside business activities to their member firm employers, governed the Majesco transactions. Rule 3030 contained an exception to the written disclosure obligation for "passive investments." According to Friedman, he considered the purchases and sales of

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[11] *See, e.g., Janet Gurley Katz*, Exchange Act Rel. No. 61449 (Feb. 1, 2010), 97 SEC Docket 25074, 25094 n.22 (citing *Abbondante*, 58 S.E.C. at 1091 n.21), appeal filed, No. 10-1068 (D.C. Cir. Mar. 26, 2010).

[12] *Gluckman*, 54 S.E.C. at 184 n.29 ("[Respondent] cannot shift responsibility for compliance with Conduct Rule 3040 to [his supervisor at member firm].") (citing *Thomas C. Kocherhans*, 52 S.E.C. 528, 531 (1995)).

[13] NASD Rule 3030 has been codified as FINRA Rule 3270. FINRA Regulatory Notice 10-49 (Dec. 2010). *See supra* note 2.

Majesco securities to be a "passive investment" under Rule 3030, and he therefore believed that he was not obligated to report the transactions to First Montauk.

Rule 3030 applies only to transactions involving non-securities products.[14] Because Friedman's purchase and sales of Majesco were securities transactions, his conduct was not an outside business activity under Rule 3030. However, even if Friedman had been correct in his belief that Rule 3030 was the applicable provision, Friedman's activities here were not passive. Although Schnaier provided the initial introduction to Majesco, Friedman toured Majesco's facilities, met with management, and provided funds for the specific purpose of purchasing the shares. Friedman also initiated contact with Glick and set the purchase price for the shares Glick purchased from Friedman and Schnaier. Friedman received half of the proceeds from the sales for his personal benefit. Such conduct constitutes active participation in the transactions.[15]

In addition, Friedman's faulty understanding of FINRA rules does not excuse his violations. At the time of the transactions at issue, Friedman had nine years of securities industry experience, was the registered principal and branch manager at the OSJ, and was responsible for the OSJ's compliance with FINRA rules, including ensuring that First Montauk received prior written notice of any private securities transactions by registered representatives, pursuant to Rule 3040. Friedman failed to consult FINRA rules or the Firm's compliance personnel before engaging in the transactions, and the Firm's compliance procedures would have put Friedman on notice, had he consulted them, of his obligation to report the transactions. He acknowledged in testimony that, instead, he unilaterally made the determination that it was not necessary to report the transactions to First Montauk. In light of these facts, Friedman's ignorance of the proper application of Rule 3040 does not excuse his violations.[16]

The record supports FINRA's finding that Friedman participated in private securities transactions outside the scope of his employment with First Montauk and that Friedman did not

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[14] *See* NASD Notice to Members 01-79 (Dec. 2001).

[15] *See Abbondante*, 58 S.E.C. at 1109 n.68 (finding that respondent's outside business activities were not "passive investments" because of his material participation in the transactions, evidenced by respondent's intentional involvement in the outside business activity at issue, his distribution of proceeds from the transaction, and his receipt of a portion of the proceeds for his personal benefit) (citing *Micah C. Douglas*, 52 S.E.C. 1055, 1058-59 (1996) (finding that completion of a questionnaire in an effort to solicit business constitutes an outside business activity)).

[16] *See, e.g., Phillipe N. Keyes*, Exchange Act Rel. No. 54723 (Nov. 8, 2006), 89 SEC Docket 792, 800 n.18 (noting that registered representative's "claimed ignorance of his obligations is only aggravated in light of his fifteen years experience in the securities industry"); *see also Ryan R. Henry*, Exchange Act Rel. No. 53957 (Jun. 8, 2006), 88 SEC Docket 592 n.13 ("A registered representative is assumed as a matter of law to have read and have knowledge of [SRO] rules and requirements") (citing *Carter v. SEC*, 726 F.2d 472, 473-74 (9th Cir. 1983); *Walter T. Black*, 50 S.E.C. 424, 426 (1990) ("[L]ack of familiarity with the NASD's rules cannot excuse [registered representative's] conduct.")).

provide written notice to First Montauk before engaging in those transactions. Accordingly, we find that Friedman violated NASD Conduct Rule 3040. A violation of a Commission or NASD Rule or regulation also constitutes a violation of Conduct Rule 2110.[17] Therefore, we also find that Friedman violated Rule 2110.

## IV.

In reviewing a disciplinary proceeding pursuant to Exchange Act Section 19(e), we must sustain FINRA's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive, oppressive, or impose an unnecessary or inappropriate burden on competition.[18] The recommended suspension under the FINRA Sanction Guidelines for violations of Rule 3040 depends partly on the dollar amount of the sales at issue: for sales of a dollar amount over $1,000,000, as here, the Sanction Guidelines recommend a suspension of twelve months to a bar.[19] Under the Sanction Guidelines for Rule 3040 violations, FINRA also considers the number of customers involved and the length of time over which the selling away occurred. The recommended fine is $5,000 to $50,000, subject to increase by adding the amount of the respondent's financial benefit from the violation.[20]

Friedman argues that FINRA abused its power when the NAC increased the length of the suspension that the Hearing Panel initially imposed from forty-five days to nine months. Friedman describes the NAC's decision as a "complete usurpation of the Hearing Panel's authority." He complains, "Neither the NAC nor [FINRA] Enforcement assert that the Hearing Panel erred as a matter of law or made a decision with respect to sanctions that was beyond its authority to make – they have simply stated that they disagree with the Hearing Panel's decision." Friedman further contends that, even if we sustain FINRA's findings of violation, the appropriate suspension for this violation would be fifteen days.

"It is the decision of the NAC, not the decision of the Hearing Panel, that is the final action of FINRA which is subject to Commission review."[21] We have repeatedly held that the NAC reviews the Hearing Panel's decision *de novo* and has broad discretion to modify the

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17 *Gluckman*, 54 S.E.C. at 185.

18 15 U.S.C. § 78s(e)(2). Friedman does not allege, and the record does not show, that FINRA's sanctions imposed an undue burden on competition.

19 *FINRA Sanction Guidelines* at 15 (2007). Although the Commission is not bound by the Sanction Guidelines, we use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2). *Wanda P. Sears*, Exchange Act Rel. No. 58075 (July 1, 2008), 93 SEC Docket 7395, 7403.

20 *Id.*

21 *Kevin M. Glodek*, Exchange Act Rel. No. 60937 (Nov. 4, 2009), 97 SEC Docket 22027, 22035 n.16 (citing *Keyes*, 89 SEC Docket at 800 n.17), *aff'd*, 2011 WL 1086638 (2d Cir. 2011).

Hearing Panel's decisions and sanctions.[22] In addition, FINRA Rules 9348 and 9349 state that, on appeal from a Hearing Panel decision, the NAC "may affirm, modify, reverse, increase, or reduce any sanction, or impose any other fitting sanction."[23] FINRA is not required to state why a lesser sanction would be insufficient in order to justify the sanction it imposed as being remedial.[24] A sanction is appropriate "so long as its choice meets the statutory requirements that a sanction be remedial and not 'excessive or oppressive.'"[25]

Applying the Sanction Guidelines to the facts presented in this appeal, we find that FINRA's sanctions were neither excessive nor oppressive. The dollar amount of the transactions at issue exceeded $1,000,000, which supports a suspension of twelve months to a bar. The NAC increased the suspension initially imposed by the Hearing Panel, but the resulting sanction, contrary to Friedman's contention, is shorter than the minimum suspension recommended under the Sanction Guidelines. The NAC found that the transactions occurred over a relatively short period of time, between a single purchase in November 2003 and sales to three parties in April and May 2004. Further, Friedman received no commissions for the transactions.

The NAC, however, also found several aggravating factors present in this case. One of the customers to whom Friedman sold the Majesco Holdings securities was a First Montauk

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[22] *Id.* at 22035 n.17 (citing *Michael B. Jawitz*, 55 S.E.C. 188, 200 & n.24 (2001) (stating that the NAC conducts a *de novo* review and has broad discretion to review any finding in the Hearing Panel decision) (citing *Timothy L. Burkes*, 51 S.E.C. 356, 359 (1993), *aff'd*, 29 F.3d 630 (9th Cir. 1994) (Table)); *see also Morton Bruce Erenstein*, Exchange Act Rel. No. 56768 (Nov. 8, 2007), 91 SEC Docket 3114, 3126 (acknowledging NAC's power to conduct a *de novo* review and make its own independent findings), *petition denied*, No. 07-15736 (11th Cir. 2008) (unpublished); *Chris Dinh Hartley*, 57 S.E.C. 767, 776 (2004) (finding FINRA's sanctions were not excessive or oppressive where the NAC increased a suspension imposed by Hearing Panel from thirty days to ninety days for violations involving registered representative selling away from his member firm employer); *James B. Chase,* 56 S.E.C. 149, 162 (2003) (finding FINRA's sanctions not excessive or oppressive where NAC increased Hearing Panel's suspension from six months to one year for violations involving unsuitable investment recommendations); *Jim Newcomb*, 55 S.E.C. 406, 418 (2001) (finding FINRA's sanctions not excessive or oppressive where NAC increased Hearing Panel's suspension from ninety days to two years for violations involving registered representative selling away from his member firm employer).

[23] These rules were also quoted in the May 8, 2009 letter from FINRA delivering the Hearing Panel decision to Friedman and informing him of his right to appeal the decision to the NAC.

[24] *Paz Sec., Inc. v. SEC,* 566 F.3d 1172, 1176 (D.C. Cir. 2009). *Cf. Horning v. SEC,* 570 F.3d 337, 346 (D.C. Cir. 2009) (holding that Commission need not state why a lesser sanction would be insufficient as long as it "articulated a reasonable, protective rationale for the penalties it selected").

[25] *Id.* at 1176.

customer.[26] Friedman's misconduct had the potential for monetary gain and did, in fact, produce large profits that were deposited into Global International's bank account for Friedman's and Schnaier's use.[27]

FINRA also found aggravating that Friedman was employed for many years as a registered representative and principal with several FINRA member firms and that he supervised compliance and regulatory matters at First Montauk's OSJ. Friedman contends that his securities industry experience is not an aggravating factor because industry experience is not included on the Sanction Guidelines' list of Principal Considerations with respect to a violation of Rule 3040. However, the Principal Considerations generally applicable to all sanction determinations specifically state, "The list is illustrative, not exhaustive; as appropriate, Adjudicators should consider case-specific factors in addition to those listed here and in the guidelines." According to the Sanction Guidelines, "The presence of one or more mitigating or aggravating factors may either raise or lower the [recommended] sanctions."

Friedman also objects to the NAC's reliance on our decision in *Keyes*,[28] which found that industry experience might serve to contradict claims of ignorance, but did not hold that industry experience is an aggravating factor. However, the fact that we did not find industry experience to be an aggravating factor in setting sanctions in that case does not mean that industry experience can never be an aggravating factor.

We agree with FINRA that Friedman's industry experience and compliance responsibility at the Firm are aggravating factors here. First Montauk's compliance manual and Friedman's written employment agreement with the Firm put him on notice of his obligation to notify the Firm of the transactions at issue. These documents also clearly state the Firm's prohibition on sales by registered representatives of products that have not been previously approved by the Firm. Despite his extensive securities industry experience and responsibilities for regulatory compliance at the Firm, Friedman unilaterally determined that he did not need to provide prior written notice of the transactions to First Montauk.

Friedman claims that certain facts mitigate his misconduct. He contends that the purchase and sale of the securities in question did not violate state or federal securities laws or FINRA rules and that he did not lead anyone to believe that the transactions were sanctioned by

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[26] Principal Consideration 8 for Rule 3040 violations is "whether respondent sold away to customers of his or her employer (member firm)." Principal Consideration 11 under Rule 3040 is "whether respondent participated in the sale by referring customers or selling the product directly to customers." *Sanction Guidelines* at 16.

[27] Principal Consideration 17 generally applicable to all sanction determinations is "whether the respondent's misconduct resulted in the potential for respondent's monetary or other gain." *Sanction Guidelines* at 7.

[28] *See supra* note 16.

First Montauk. FINRA considered this claim and appropriately concluded that, while actively misleading the purchasers regarding whether the transactions were sanctioned by First Montauk might have been aggravating, the absence of such conduct does not mitigate the violations.[29] This is because an associated person should not be rewarded for acting in compliance with the securities laws and with his duties as a securities professional.[30]

Friedman also notes that the Hearing Panel specifically found that there was no evidence that Friedman misled First Montauk or attempted to conceal the transactions from First Montauk, and he complains that the NAC rejected this as a mitigating factor, instead noting that Friedman's failure to report the transactions as required under Rule 3040 "had the effect of concealing the activity from the appropriate Firm personnel." Every violation of Rule 3040, by definition, involves the failure to provide the requisite prior written notice of a private securities transaction. Such violations may be aggravated by a registered representative taking affirmative actions to mislead the member firm, but this does not mean that the absence of misleading conduct is mitigating.[31]

Friedman also contends that it is a mitigating factor that the Hearing Panel found that he did not intend to violate Rule 3040 and that his violation of Rule 3040 was a result of his negligent failure to understand the rule. Friedman characterizes the Hearing Panel's finding that he acted negligently as a credibility determination, to which the NAC should have deferred. The NAC did not, however, dispute the Hearing Panel's finding that Friedman was unaware of his obligations. Rather, it found that this lack of awareness was not mitigating, especially in light of Friedman's significant industry experience. Further, we have consistently held that registered representatives are responsible for understanding their regulatory obligations, and ignorance of those obligations does not excuse a violation of an SRO's Rules.[32]

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29 *Michael Frederick Siegel*, Exchange Act Rel. No. 58737 (Oct. 8, 2008), 94 SEC Docket 10519 n.45 (finding, in a Rule 3040 case, among other things, that it was not mitigating that transactions at issue did not violate securities laws or FINRA rules and that registered representative did not give impression that member firm sanctioned transactions. "While the presence of any of these factors could constitute aggravating circumstances justifying an increase in sanctions, their absence is not mitigating."), *petition denied in part and remanded in part*, 592 F.3d 147 (D.C. Cir. 2010).

30 *Id.* at 10519 n.45 (citing *Keyes*, 89 SEC Docket at 801 & n.20).

31 *Id.* at 10519 n.45.

32 *Keyes*, 89 SEC Docket at 801 n.19; *Siegel*, 94 SEC Docket at 10518 n.42 (citing *Prime Investors, Inc.*, 53 S.E.C. 1, 5 & n.12 (1997) (finding a claimed ignorance of the law not mitigating)).

Contrary to Friedman's claim, the fact that the customers did not lose money or complain about the transactions does not mitigate Friedman's misconduct.[33] Even if the customers profited from the transactions at issue, the failure of a registered representative to adhere to the requirements of Rule 3040 undermines the ability of member firms to monitor effectively the securities activities of their associated persons.

The Sanction Guidelines recommend a fine of between $5,000 and $50,000 for violations of Rule 3040. The Sanction Guidelines further state that "Adjudicators should increase the recommended fine amount by adding the amount of a respondent's financial benefit." FINRA initially determined that a $25,000 fine, in the middle of the recommended range, was appropriate for Friedman's violations. Then, FINRA determined that Friedman received $550,000 from the transactions at issue. FINRA could have increased the fine by this amount, which would have resulted in a $575,000 fine. Instead, FINRA determined only to increase the fine by $52,500, the amount of Friedman's proceeds from the sale to First Montauk customer Glick. This determination was appropriate because Friedman's misconduct deprived the customer of the Firm's oversight with respect to this transaction. We do not find that this determination resulted in an excessive or oppressive fine, especially considering the total amount of Friedman's financial gain from the three sales.

We agree with FINRA that Friedman's conduct indicates a "very serious violation" and warrants the imposition of meaningful sanctions. We repeatedly have stated that the prohibition on private securities transactions is fundamental to an associated person's duty to his customers and his firm.[34] Such misconduct deprives investors of a brokerage firm's oversight, due diligence, and supervision, protections investors have a right to expect.[35] Friedman continues to be employed as a registered representative with a FINRA member firm, and the securities industry "presents a great many opportunities for abuse and overreaching, and depends very heavily on the integrity of its participants."[36] Given Friedman's lack of understanding of his obligations as a securities professional and his continued employment in the securities industry, a nine-month suspension will have the remedial effect of protecting the investing public from harm

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[33] *See Ronald J. Gogul*, 52 S.E.C. 307, 312 n.20 (1995) (finding the fact that no customer complained about an investment was "not persuasive" in support of respondent's argument that sanctions should be reduced).

[34] *See Keyes*, 89 SEC Docket at 800 n.18 (citing *Gluckman*, 54 S.E.C. at 192; *Gerald James Stoiber*, 53 S.E.C. 171, 180 (1997)).

[35] *Anthony H. Barkate*, 57 S.E.C. 488, 501 n.27 (2004) (citing *Ronald W. Gibbs*, 52 S.E.C. 358, 365 (1995)).

[36] *Bernard D. Gorniak*, 52 S.E.C. 371, 373 (1995). *See also, e.g.*, *Frank Kufrovich*, 55 S.E.C. 616, 627 (2002) ("A propensity for dishonest behavior is of particular concern in the securities industry, an industry that presents numerous opportunities for abuses of trust."); *Mayer A. Amsel*, 52 S.E.C. 761, 768 (1996) (noting that the securities industry is "rife with opportunities for abuse").

by impressing upon Friedman and other registered representatives the importance of complying with Rule 3040 by providing written notice before engaging in private securities transactions.[37] We find that the nine-month suspension and $77,500 fine achieve the goals of being remedial and deterring future violations, without being excessive or oppressive.[38]

An appropriate order will issue.

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

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[37] *See Paz*, 494 F.3d 1059, 1066 (D.C. Cir. 2007) (stating that "general deterrence" may be "considered as part of the overall remedial inquiry" (quoting *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005)), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009).

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64486 / May 13, 2011

Admin. Proc. File No. 3-14016

| |
|---|
| In the Matter of<br><br>HARRY FRIEDMAN<br>c/o Law Offices of Isaac M. Zucker, PLLC<br>600 Old Country Road, Suite 321<br>Garden City, New York 11530<br><br>For Review of Disciplinary Action Taken by<br><br>FINRA |

ORDER SUSTAINING ACTION OF REGISTERED SECURITIES ASSOCIATION

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

ORDERED that the disciplinary action taken by FINRA against Harry Friedman, and FINRA's assessment of costs, be, and they hereby are, sustained.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

[E]XCHANGE ACT OF 1934
[...]91 / May 13, 2011

[I]N[VESTMEN]T ADVISERS ACT OF 1940
[...]203 / May 13, 2011

[ADMINIS]TRATIVE PROCEEDING
[...]-14381

[In the] Matter of

GREGORY L. OLDHAM,

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 Gregory L. Oldham ("Respondent" or "Oldham").

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

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consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

**III.**

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

1. From August 18, 2004 through December 31, 2008, Respondent was a registered representative at Advanced Planning Securities, Inc. ("Advanced Planning"), a broker-dealer that, from at least June 1, 2004 until February 24, 2009, was registered with the Commission pursuant to Section 15(b) of the Exchange Act. Oldham is currently a registered representative with Waterford Investors Services, Inc., a broker-dealer registered with the Commission, and an investor adviser representative at Advanced Planning Capital Planning Corporation, an investment adviser registered with the Commission. Oldham, age 59, resides in Kenosha, Wisconsin.

2. On April 20, 2011, a final judgment was entered by consent against Oldham, permanently enjoining him from future violations of Sections 5(a) and 5(c) of the Securities Act of 1933, in the civil action entitled Securities and Exchange Commission v. Charles C. Slowey, Jr., et al., Civil Action Number 09 Civ. 4547 (LDW) (ETB), in the United States District Court for the Eastern District of New York.

3. The Commission's complaint alleged that from approximately March 2004 through August 2006, Oldham offered and sold securities for which there was no registration statement in effect and for which no exemption from the registration requirements applied.

**IV.**

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Oldham be, and hereby is barred from association with any broker, dealer, or investment adviser, with the right to reapply for association after eighteen (18) months 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

Commissioner Walter
not participating

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64492 / May 13, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14382**

**In the Matter of**

**MICHAEL P. WATSON,**

**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 P. Watson ("Respondent" or "Watson").

**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 at least October 2004 through February 2009, Respondent was the sole owner and managing member of Mike Watson Capital, LLC ("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 26, 2011, a final judgment was entered by consent against Watson, 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 2:11-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 Watson, 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 Watson 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 Watson's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Watson 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

Commissioner Paredes not participating

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

**SECURITIES ACT OF 1933**
**Release No. 9207 / May 13, 2011**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64493 / May 13, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3204 / May 13, 2011**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 29669 / May 13, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14383**

**In the Matter of**

**DANIEL M. HUGHES,**

**Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

**I.**

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

## II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

## III.

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

### Summary

1. From May 2008 to April 2009, Hughes, a principal and director of a registered investment adviser, made oral misrepresentations to one of his investment advisory clients (the "Client") in order to conceal \$3.6 million in index options trading losses incurred by Hughes. During this same period, Hughes falsified several of the Client's brokerage account statements and delivered these falsified statements to the Client's private banker.

### Respondent

2. Hughes, age 46, resides in Cincinnati, Ohio. From September 5, 2007 through April 20, 2009, Hughes served as one of the three principals of Anderson Hills Investment Advisors, Inc. ("Anderson Hills), an investment adviser registered with the Commission during that time. Shortly after Hughes joined the firm and until his departure, client accounts attributable to Hughes comprised a majority of the firm's assets under management.

### Other Relevant Entities

3. Anderson Hills is an Ohio corporation formerly headquartered in Cincinnati, Ohio that was registered with the Commission as an investment adviser under the name Anderson Hills Investment Advisors, Inc. At all times relevant, Anderson Hills was doing business under the name Fossett Hughes and Jabin Investment Advisors, Inc. As of May 1, 2008, Anderson Hills provided discretionary and non-discretionary investment management services to over 200 client accounts and managed approximately \$46.1 million of assets. On June 15, 2009, Anderson Hills withdrew its registration with the Commission and ceased providing investment advisory services.

## Background

4. From February 2000 to September 2007, Hughes was a registered representative associated with a registered broker-dealer (the "Broker-Dealer"), which itself was associated with a large bank (the "Bank"), where the Client maintained a private banking relationship. In December 2004, the Client's Private Banker (the "Private Banker") introduced him to Hughes for the purpose of opening a securities account. The Client subsequently opened a securities account and, from 2005 to 2006, the Client's account with Hughes generated profits.

5. In September 2007, Hughes left the Broker-Dealer to join Anderson Hills. That same month, the Client closed his account at the Broker-Dealer to become a client of Hughes at Anderson Hills. The Client was Hughes's largest, most important client at Anderson Hills.

6. The Client transferred approximately $12.2 million in funds and securities to his new account at Anderson Hills. The Client intended that this account would fund principal and interest payments, totaling $350,000 per month, for a real estate development loan that he continued to maintain with the Bank, as well as construction costs associated with this real estate development project. Hughes understood that funding the loan and construction costs was the Client's investment objective. Hughes, the Client, and the Bank agreed that Hughes would send the Client's monthly account statements to the Client's Private Banker so that the Private Banker could continue to monitor the account's performance.

7. At the time the Client opened the account in September 2007, the Client executed various documents granting Anderson Hills and Hughes trading authority on the account and an application to open an account with the custodian for Anderson Hills, which was a registered broker-dealer (the "Custodian").

8. Pursuant to the firm's policy and practice, each client of Anderson Hills was to receive original account statements and trade confirmations directly from the Custodian. Notwithstanding this practice, in October 2007, Hughes permitted the Client to authorize Hughes to obtain the Client's online account statements and trade confirmations and to discontinue the delivery of paper statements to the Client. The Client did not possess an email account at the time and did not know how to access his account online. The Client relied on frequent conversations with Hughes and periodic discussions with his Private Banker to monitor the performance of his account. Hughes downloaded the Client's online statements and forwarded them to the Client's Private Banker to review.

9. Although Hughes's trading generated profits for the Client in 2005 and 2006, in 2007, Hughes's trading resulted in substantial losses. The Client first learned that he might have suffered losses as a result of Hughes' trading in November 2007, during a meeting with representatives of the Bank and the Broker-Dealer affiliated with the Bank. The Client subsequently questioned Hughes about these potential losses, and Hughes responded that the meeting attendees did not understand his trading strategy and that the losses were temporary and had been recouped.

10. Shortly thereafter, in late January or early February 2008, the Client received a call from the Custodian notifying him that his account had lost approximately $4.5 million in January 2008. The Client called Hughes and told him to stop trading the account. Hughes called the Client back within a week and told him that he had designed an options trading strategy pursuant to which the Client could expect to achieve the positive returns that he had been receiving previously and under which the most the Client could lose was $500,000. Based upon these representations, the Client agreed to continue trading with Hughes. The Client communicated his agreement with Hughes regarding the new trading strategy and the loss limitation to the Bank, which had requested assurances that the Client could continue to meet his loan obligations. Hughes was directed to continue to send the Client's monthly account statements to the Private Banker so that the Private Banker could monitor the performance of the account.

11. Thereafter, during the period from March 2008 through April 2009, the Client continued to monitor the performance of his account with Hughes through frequent phone calls with Hughes, and on occasion, he spoke with his Private Banker about his account balances. Throughout this period, Hughes repeatedly told the Client that the account was not incurring losses and assured him that the account balances either remained constant or that the account was profitable. The Client relied upon Hughes's representations and his conversations with his Private Banker, who had received the account statements.

12. The account lost approximately $200,000 in February 2008 but gained approximately $460,000 and $100,000 in March and April 2008, respectively. However, during May 2008, the account suffered a $1 million loss as a result of Hughes's trading. Upon this loss, Hughes began falsifying the account statements that he downloaded from the Custodian's website to conceal the investment-related losses suffered by the account and to make the account appear profitable. Hughes forwarded the falsified statements to the Private Banker at the Bank. Thereafter, Hughes's trading continued to result in substantial losses; and Hughes continued to create and deliver falsified accounting statements.

13. In total, Hughes, through his oral misrepresentations and falsified account statements, concealed $3.6 million in trading losses.

14. As of March 31, 2009, the Client's account held less than $50,000, far less than the amount needed to cover the customary $350,000 monthly withdrawal. On April 16, 2009, Hughes called the Client to inform him that the value of his account was substantially less than what Hughes had orally represented to him and the amounts that were shown on the statements that Hughes had provided to the Client's Private Banker at the Bank. During this call, Hughes admitted to the Client that he falsified the Client's account statements and that the losses in the account were attributable to options trading.

15. As a result of the conduct described above, Hughes 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, offer, or sale of securities.

16. As a result of the conduct described above, Hughes willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser.

**Disgorgement and Civil Penalties**

17. Respondent submitted a sworn Statement of Financial Condition dated December 9, 2010 and other evidence and has asserted his inability to pay disgorgement plus prejudgment interest or 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 Respondent Hughes's Offer.

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Hughes shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act.

B. Respondent Hughes shall 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 and prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

C. Any reapplication for association by 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 disgorgement of $8,475 and prejudgment interest of $604, but that payment of such amount is waived based upon Respondent's sworn representations in his Statement of Financial Condition dated December 9, 2010 and other documents submitted to the Commission. Based upon those same representations, the Commission also is not imposing a penalty against Respondent.

E. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission (1) to reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) to seek an order directing payment of disgorgement, pre-judgment interest, and 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 disgorgement, interest, or a penalty should not be ordered; (3) contest the amount of disgorgement, interest, or penalty to be ordered; 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

Chairman Schapiro, Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64496 / May 13, 2011**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3281 / May 13, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14384**

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|---|---|
| **In the Matter of**<br><br>**GEORGE B. DOHERTY,**<br><br>**Respondent.** | **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 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 George B. Doherty ("Doherty" 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 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 that:[1]

[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.

## Summary

1. These proceedings concern George B. Doherty's role in the improper recognition of revenue by GSI Group Inc. ("GSI" or the "Company"). Doherty caused GSI to recognize revenue from certain significant transactions in its Semiconductor Systems segment (the "Systems Division") that materially impacted GSI's financial results even though revenue recognition was prohibited pursuant to Generally Accepted Accounting Principles ("GAAP"). In April 2008, Doherty learned that GSI may have failed to provide unique, customized, factory automation software, for which it did not have vendor specific objective evidence of value, in connection with the sale of six semiconductor systems to a Taiwanese customer and, accordingly, may have improperly recognized nearly $5 million in revenue during the fourth quarter of fiscal 2007. In addition, in connection with the sale of several production systems to a Korean customer, Doherty incorrectly concluded that an as yet-undeveloped multiple pulse laser (the "Undeveloped Laser") was substantially similar to a single pulse laser (the "Single Pulse Laser") that GSI had previously sold, even though he possessed information indicating that the two lasers were in fact not substantially similar. As a result, Doherty caused GSI to improperly recognize over $16 million in revenue from these sales during the first and second quarters of fiscal year 2008.

## Respondent

2. **George B. Doherty**, 48, of Lincoln, Massachusetts, worked for GSI Group, Inc. from 2004 through May 2009. Doherty became GSI's corporate controller in August 2006, a position he held until May 2009. For his work in 2007, Doherty received incentive-based compensation including, but not limited to, a cash bonus. Doherty has been a CPA licensed in Massachusetts since 1989.

## Other Relevant Party

3. **GSI**, a New Brunswick, Canada corporation with its principal place of business in Bedford, Massachusetts, manufactures and sells laser systems and other technology products. GSI's stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and traded on the NASDAQ National Market System until July 31, 2006. From July 31, 2006 until April 15, 2010, GSI's stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the NASDAQ Global Market. On April 15, 2010, GSI's stock was delisted from the NASDAQ Global Market because it was delinquent in its Commission filings, deregistered from Section 12(b) of the Exchange Act, and reverted back to its designation under Section 12(g) of the Exchange Act. On November 20, 2009, GSI filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code in the U.S. Bankruptcy Court for the District of Delaware. On May 27, 2010, the U.S. Bankruptcy Court for the District of Delaware confirmed GSI's plan for reorganization. On July 23, 2010, GSI completed a rights offering and emerged from the Chapter 11 proceeding. On December 4,

2008, GSI announced that past financial statements filed with the Commission could no longer be relied upon due to errors discovered with GSI's recognition of revenue for those periods. On April 13, 2010, GSI filed restated annual and quarterly financial statements for the periods contained within the fiscal years 2004, 2005, 2006, 2007, and 2008. Effective February 14, 2011, GSI re-registered its common stock pursuant to Section 12(b) of the Exchange Act and is currently listed on the Nasdaq Global Select Market.

## **Facts**

Background

4. GSI's Systems Division manufactures production systems that it sold to both domestic and international customers. GSI's production systems generally had both hardware (including lasers) and software components (including, in certain instances, customized, vendor specific, factory automation software) and required on-site installation by GSI personnel.

5. From mid-2007 through October 2008, Doherty, assisted by the assistant corporate controller, participated in the determination when to recognize revenue from Systems Division sales. Systems Division staff documented the basic terms of a transaction in a sales order approval form, which was reviewed and, depending on the size of the order, approved by varying levels of sales, finance and management staff. Transactions generally were automatically recognized as revenue upon shipment. Prior to the close of the quarter, the corporate controller and assistant corporate controller reviewed the documents related to each transaction and determined whether to recognize or defer revenue for the period.

The Korean Transaction

6. During November 2007, a Korean customer agreed to purchase from GSI ten systems for nearly $1 million per system. Each system was equipped with a laser previously sold by GSI. GSI agreed to upgrade these systems by replacing the original lasers with a laser that had not yet been developed (the "Undeveloped Laser") when it became available.[2] As a final condition, the customer demanded that GSI upgrade five systems that the customer had previously purchased with Undeveloped Lasers once they became available.

7. In November 2007, one of GSI's product line managers (the "PLM") sent a letter to the Korean customer confirming GSI's obligation to upgrade the five systems with Undeveloped Lasers. The PLM did not copy anyone on the letter, and neither the letter nor the terms therein were provided to GSI's finance department (the "Finance Department"). The PLM completed the sales order approval form for the transaction representing to the Finance Department that, among other things, GSI had not made any "promises or guarantees for future deliverables (systems improvements, software upgrades, etc)." The PLM also signed quarterly

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2 During this period, GSI had two undeveloped lasers – a Multiple Pulse Infrared Laser and a Multiple Pulse Green Laser –that were to be upgraded in the production systems ordered by the Korean customer during 2007 and 2008. Neither of the lasers were substantially similar to the original lasers in the production system and, for the purposes of this Order, will be referred to collectively as the Undeveloped Laser(s).

certifications, for the Finance Department stating that he was unaware of any side transactions or contingencies.

8. In December 2007, the PLM, Doherty, the chief financial officer, the assistant controller, and the general manager of the Systems Division (the "Systems GM") met to discuss whether they could establish fair value for the Undeveloped Lasers and thus recognize revenue from the transaction. During these discussions, they concluded that GSI could establish fair value for the Undeveloped Laser if they could find a substantially similar laser that GSI had previously sold. Shortly thereafter, the PLM and others identified a laser (the "Identified Laser") as being substantially similar to the Undeveloped Laser.

9. In fact, the Identified Laser was not substantially similar to the Undeveloped Laser for the purposes of recognizing revenue. Among other things, the Undeveloped Laser was a unique, undeveloped product that had significantly different future application potential. In addition, the PLM had communicated to Doherty and others that the Undeveloped Lasers were unique, product innovation, worth substantially more than the Identified Laser.

10. On December 20, 2007, Doherty emailed the PLM a draft of a memo (the "Fair Value Memo") concluding that the Undeveloped Laser and the Identified Laser were substantially similar, which he asked the PLM to finalize and sign. The PLM, however, initially declined to sign the memo on the grounds that the lasers were different. Doherty then called the Systems GM and told him that if the PLM did not sign the memo, the company would not recognize revenue from the sale. The Systems GM indicated that he would talk to the PLM and, that same evening, the PLM emailed Doherty the signed Fair Value Memo.

11. In the first and second quarters of 2008, the Korean customer ordered eight additional systems and corresponding upgrades for Undeveloped Lasers. The PLM signed another memo (to which the Fair Value Memo was attached) representing that the Undeveloped Laser to be used in these systems was substantially similar to the Identified Laser when in fact the lasers were not substantially similar. As a result, GSI improperly recognized revenue for the systems. GSI provided the memos to the company's external auditors as part of their second quarter review, but did not inform them of the PLM's initial reluctance to sign the Fair Value Memo.

12. During the first and second quarter of 2008, GSI recorded in its books and records and reported in its financial statements filed with the Commission over $8.9 million and $7.1 million in revenue, respectively, from the transactions with the Korean customer. However, GSI should not have recognized any revenue from these transactions during these periods because GSI had not delivered the Undeveloped Lasers, nor had it properly established fair value for the Undeveloped Laser in accordance with GAAP.

The Taiwanese Transaction

13. In or around January 2007, the PLM began negotiating a sale of six systems to a Taiwanese customer. The initial quotation specifically referenced a Tool Automation

Specifications ("TAS") Agreement that related to the customer specifications or factory automation software that GSI would be obligated to provide.

14. During this same time, the primary engineer responsible for creating the factory automation software informed the PLM that implementing all the TAS specifications would be "a huge task," requiring over an additional 2000 hours of labor, would cost between $450,000 to $600,000, and could "not possibly be accomplished in the required time frame."

15. In March 2007, the Taiwanese customer ordered the six systems for approximately $7 million and specifically referenced compliance with the TAS as part of the arrangement. The PLM never informed the Finance Department that, as part of the transaction, the customer required customized software that would not be completed until several months after the systems had been installed and were operational. GSI booked the orders and, between May and October 2007, shipped the six systems.

16. When the customer accepted the first system during the fourth quarter of 2007, GSI recognized nearly $5 million and deferred nearly $2 million in revenue from the six systems that had shipped even though GSI still owed the customer the customized software. Because GSI had not delivered the customized software, and because it did not have fair value for the software, this revenue should not have been recognized.

17. On March 4, 2008, Doherty received an email from GSI's Taiwan-based sales manager stating that while the Taiwanese customer had accepted the first system, there were factory automation issues with the remaining five systems and that GSI will not collect the final acceptance as scheduled. Doherty forwarded the email to the Systems GM, the assistant corporate controller and others, stating, "This does not look perfunctory." Doherty did not take any additional action to learn what, if any, factory automation issue existed with the Taiwanese customer until March 13, 2008, when GSI's chief financial officer asked him to look into the issue.

18. On March 20, 2008, Doherty emailed the PLM and others asking whether there existed a factory automation issue with respect to the Taiwanese customer. In response, the PLM told the corporate controller that GSI owed the customer "Phase II" factory automation, which GSI hoped to complete by the second quarter of 2008. The PLM provided Doherty with a copy of the TAS, which he stated contained the Phase II factory automation specifications.

19. In or around March 2008, the assistant corporate controller informed Doherty that the failure to provide factory automation may impact the revenue that GSI had previously recognized, which could result in a restatement. On April 3, 2008, Doherty emailed the assistant corporate controller, stating: "Please don't dig into these unless it blows up down the road. Let's work on getting things right going forward." On April 4, 2008, the assistant controller emailed Doherty, stating that, among other things, the Finance Department had not been aware of any future deliverable. On April 6, 2008, Doherty again emailed the assistant corporate controller: "When we go to the acceptance method this issue goes away. Let's dig into that once we get the quarter close behind us." Doherty did not properly investigate the matter and did not disclose the

potential existence of undelivered factory automation software to the external auditors until November 2008.

20. During the fourth quarter of 2007, GSI recorded in its books and records and reported in its financial statements filed with the Commission nearly $5 million in revenue from sales to the Taiwanese customer. However, GSI should not have recognized any revenue from this transaction during this period because GSI had not delivered the customized, factory automation software required under the customer agreement.

Impact on Financial Statements

21. The misleading financial information that resulted from the improper recognition of revenue from the Korean and Taiwanese transactions was material because it overstated (1) revenues by 7.1% in the fourth quarter of 2007, by 1.6% for fiscal year 2007, 14.7% in the first quarter of 2008, and by 12.1% in the second quarter of 2008; and (2) revenues for GSI Group's Systems Division by, 21.5% in the fourth quarter of 2007, by 4.3% during fiscal year 2007, by 39.3% in the first quarter of 2008, and by 48.0% in the second quarter of 2008.[3]

22. As a result of the conduct described above, GSI's Form 10-K for the company's fiscal year 2007, as well as the Forms 10-Q for the quarters ended March 31, 2008 and June 30, 2008, contained false and misleading statements concerning GSI's financial results. For those two quarterly periods in 2008, GSI issued press releases, subsequently filed with the Commission on Forms 8-K, containing the false and misleading financial information.

Violations

23. As a result of the conduct above, Doherty caused GSI's violations of Sections 13(a) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-11, and 13a-13 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents, and annual, quarterly and other 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, and require 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 conformity with generally accepted accounting principles.

24. As a result of the conduct above, Doherty willfully[4] violated Rule 13b2-1 under the Exchange Act in that he indirectly caused to be falsified a book, record, or account subject to

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3 GSI also overstated pre-tax income by $1.4 million (6.4%) for fiscal year 2007, $3.6 million (5,206.0%) for the first quarter of 2008, and $2.9 million (1,443.1%) for the second quarter of 2008 as a result of the improper revenue recognition for the Korean and Taiwanese transactions.

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

Section 13(b)(2)(A) of the Exchange Act, which requires all reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and disposition of their assets.

## IV.

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

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

A. Respondent Doherty cease and desist from committing or causing any violations and any future violations of Sections 13(a) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, and 13b2-1 thereunder.

B. IT IS FURTHER ORDERED that Respondent shall pay a civil money penalty in the amount of $20,000.00 and disgorgement of $9,846 plus prejudgment interest of $1,330, for a total payment of $31,176, to the United States Treasury. Respondent shall satisfy this obligation by paying (1) $10,000 within ten (10) business days after entry of this Order; (2) $7,058 within 180 days from the entry of this Order; (3) $7,059 within 270 days from the entry of this Order; and (4) $7,059 within 365 days from 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 disgorgement and prejudgment interest, plus any additional interest accrued pursuant to SEC Rule of Practice 600, 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, 100 F Street, NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies George Doherty as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Securities and Exchange Commission, 33 Arch Street, 23rd Floor, Boston, MA 02110.

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. 64497 / May 13, 2011**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3282 / May 13, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14385**

| | |
|---|---|
| **In the Matter of**<br><br>**PETER DISESSA,**<br><br>**Respondent.** | **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 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 Peter DiSessa ("DiSessa" 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 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 that:[1]

**Summary**

1. These proceedings concern Peter DiSessa's role in the improper recognition of revenue for certain material transactions by GSI Group, Inc. ("GSI" or "the company") during 2007 and 2008 (the "Relevant Period"). DiSessa and others caused GSI to recognize revenue from certain significant transactions in its Semiconductor Systems segment (the "Systems Division") that materially impacted GSI's financial results even though revenue recognition for each of these transactions was prohibited pursuant to Generally Accepted Accounting Principles ("GAAP"). For example, during fiscal year 2007, DiSessa entered into a side agreement that materially altered the terms of an arrangement between GSI and a Korean customer in a way that made the revenue from the transaction not eligible for inclusion in GSI's financial statements at that time, and he failed to disclose those terms to GSI's financial staff or external auditors. In connection with that same transaction, DiSessa signed a memo prepared by GSI's corporate controller indicating that GSI had vendor specific objective evidence ("VSOE") of value for an undeveloped laser when, in fact, DiSessa knew or should have known that it did not. As a result, during the first and second quarters of fiscal year 2008, GSI improperly recorded in its books and records and reported in its filings with the Commission over $16 million in revenue that should have been deferred to later quarters or fiscal years. In addition, during the fourth quarter of fiscal year 2007, DiSessa also caused GSI to improperly recognize nearly $5 million in revenue from a Taiwanese customer, even though he knew or should have known that GSI had not completed all the necessary customized software automation, a fact that made the revenue ineligible for recognition at that time under GAAP.

**Respondent**

2. **Peter DiSessa**, 59, of Winthrop, Massachusetts, worked for GSI Group, Inc. from 2006 through May 2009 as a product line manager. During the Relevant Period, DiSessa earned a bonus of $18,252.

**Other Relevant Party**

3. **GSI**, a New Brunswick, Canada corporation with its principal place of business in Bedford, Massachusetts, manufactures and sells laser systems and other technology products. GSI's stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and traded on the NASDAQ National Market System until July 31, 2006. From July 31, 2006 until April 15, 2010, GSI's stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the NASDAQ Global Market. On April 15, 2010, GSI's stock was delisted from the NASDAQ Global Market because it was delinquent in its Commission filings,

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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.

deregistered from Section 12(b) of the Exchange Act, and reverted back to its designation under Section 12(g) of the Exchange Act. On November 20, 2009, GSI filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code in the U.S. Bankruptcy Court for the District of Delaware. On May 27, 2010, the U.S. Bankruptcy Court for the District of Delaware confirmed GSI's plan for reorganization. On July 23, 2010, GSI completed a rights offering and emerged from the Chapter 11 proceeding. On December 4, 2008, GSI announced that past financial statements filed with the Commission could no longer be relied upon due to errors discovered with GSI's recognition of revenue for those periods. On April 13, 2010, GSI filed restated annual and quarterly financial statements for the periods contained within the fiscal years 2004, 2005, 2006, 2007, and 2008. Effective February 14, 2011, GSI re-registered its common stock pursuant to Section 12(b) of the Exchange Act and is currently listed on the Nasdaq Global Select Market.

## Facts

Background

4. During the Relevant Period, GSI's Systems Division manufactured production systems that it sold to both domestic and international customers. GSI's production systems generally had both hardware (including lasers) and software components (including, in certain instances, customized, vendor specific, factory automation software) and required on-site installation by GSI personnel. DiSessa was the product line manager for one of the Systems Division's product lines.

5. From mid-2007 through October 2008, GSI's corporate controller, assisted by the assistant corporate controller, made the determination when to recognize revenue from Systems Division sales. Systems Division staff – including DiSessa – documented the basic terms of a transaction in a sales order approval form, which was reviewed and, depending on the size of the order, approved by varying levels of sales, finance and management staff. Transactions generally were automatically recognized as revenue upon shipment. Prior to the close of the quarter, the corporate controller and assistant corporate controller reviewed the documents related to each transaction and determined whether to recognize or defer revenue for the period.

The Korean Transaction

6. During November 2007, a Korean customer agreed to purchase from GSI ten systems for nearly $1 million per system. Each system was equipped with a laser previously sold by GSI. GSI agreed to upgrade these systems by replacing the original lasers with a laser that had not yet been developed (the "Undeveloped Laser") when it became available.[2] As a final condition, the customer demanded that GSI upgrade five systems that the customer had previously purchased with Undeveloped Lasers once they became available.

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[2] During this period, GSI had two undeveloped lasers – a Multiple Pulse Infrared Laser and a Multiple Pulse Green Laser – that were to be upgraded in the production systems ordered by the Korean customer during 2007 and 2008. Neither of the lasers was substantially similar to the original lasers in the production system and, for the purposes of this Order, will be referred to collectively as the Undeveloped Laser(s).

7. In November 2007, DiSessa sent a letter to the Korean customer confirming GSI's obligation to upgrade the five systems with Undeveloped Lasers. Although the letter was reviewed by at least some members of the Systems Division, DiSessa did not copy anyone on the letter, and neither the letter nor the terms therein were provided to GSI's finance department (the "Finance Department"). DiSessa completed the sales order approval form for the transaction representing, among other things, that GSI had not made any "promises or guarantees for future deliverables (systems improvements, software upgrades, etc)." DiSessa also signed a quarterly certification for the Finance Department stating that he was unaware of any side transactions or contingencies connected to the transaction. DiSessa knew that this certification (and the representations therein) would be used by GSI in preparing its financial statements and would be provided to GSI's independent auditor in connection with the quarterly reviews of GSI's financial statements.

8. In December 2007, DiSessa, members of the Finance Department staff, and the Systems GM met to discuss whether they could establish VSOE of value, or "fair value," for the Undeveloped Lasers and thus recognize revenue from the transaction. During these discussions, they concluded that GSI could establish fair value for the Undeveloped Laser if they could find a substantially similar laser that GSI had previously sold. Shortly thereafter, they identified a laser (the "Identified Laser") as being substantially similar to the Undeveloped Laser.

9. In fact, the Identified Laser was not substantially similar to the Undeveloped Laser for the purposes of recognizing revenue. Among other things, the Undeveloped Laser was a unique, undeveloped product that had significantly different future application potential. In addition, on several occasions DiSessa had communicated to the Finance Department and others that the Undeveloped Lasers were worth substantially more than the Identified Laser.

10. On December 20, 2007, the corporate controller emailed DiSessa a draft of a memo (the "Fair Value Memo") concluding that the Undeveloped Laser and the Identified Laser were substantially similar, which he asked DiSessa to finalize and sign. DiSessa, however, initially declined to sign the memo on the grounds that the lasers were different. The corporate controller then called the Systems GM and told him that if DiSessa did not sign the memo, the company would not recognize revenue from the sale. The Systems GM indicated that he would talk to DiSessa and, that same evening, DiSessa emailed the corporate controller the signed Fair Value Memo. DiSessa knew or should have known that this Fair Value Memo (and the representations therein) would be used by GSI in preparing its financial statements and would be provided to GSI's independent auditor in connection with the quarterly reviews of GSI's financial statements.

11. In the first and second quarters of 2008, the Korean customer ordered eight additional systems and corresponding upgrades for Undeveloped Lasers. DiSessa signed another memo (to which the Fair Value Memo was attached) representing that the Undeveloped Laser to be used in these systems was substantially similar to the Identified Laser when in fact the lasers were not substantially similar. As a result, the Finance Department again used the Fair Value Memo to improperly recognize revenue for the systems.

12. During the first and second quarter of 2008, GSI recorded in its books and records and reported in its financial statements filed with the Commission over $8.9 million and $7.1 million in revenue, respectively, from the transactions with the Korean customer. However, GSI should not have recognized any revenue from these transactions during these periods because GSI had not delivered the Undeveloped Lasers, nor had it properly established fair value for the Undeveloped Laser in accordance with GAAP.

The Taiwanese Transaction

13. In or around January 2007, DiSessa supported the Systems Division sales department in the negotiation of a sale of six systems to a Taiwanese customer. The initial proposal specifically referenced a Tool Automation Specifications ("TAS") Agreement that related to the customer specifications or factory automation software that GSI would be obligated to provide.

14. During this same time, the primary engineer responsible for creating the factory automation software informed DiSessa that implementing all the TAS specifications would be "a huge task," requiring over an additional 2000 hours of labor, would cost between $450,000 to $600,000, and could "not possibly be accomplished in the required time frame."

15. In March 2007, the Taiwanese customer ordered the six systems and specifically referenced compliance with the TAS as part of the arrangement. The purchase order documentation, including the TAS, was made available to the Finance Department staff. DiSessa and the Systems Division's management staff generally understood that all of the factory automation software obligations referenced in the TAS would not likely be completed by the time the systems were shipped. DiSessa, however, never informed the Finance Department that, as part of the March transaction, the customer required factory automation software that would not likely be completed until several months after the systems had been installed and were operational. GSI booked the order and, between May and October 2007, shipped and installed the six systems. Although the systems were operational, GSI did not complete all the factory automation obligations required under the agreement.

16. In late September 2007, GSI's Finance Department told DiSessa and other Systems Division personnel that GSI could not agree to any upgrades, contingencies, or future deliverables if it wished to recognize the revenue from the transaction. DiSessa responded with an email specifically stating that "there are NO upgrades or contingencies," even though he knew that GSI had agreed to provide the customer with unique, customized software. DiSessa also signed a quarterly certification stating that he was unaware of any contingencies or side agreements connected to the transaction. When the customer accepted the first system during the fourth quarter of 2007, GSI recognized in its financial statements nearly $5 million in revenue for that quarter from the six systems that had shipped, even though GSI still owed the customer the customized software. Because GSI had not delivered the customized software, and because it did not have fair value for the software, this revenue should not have been recognized at that time. DiSessa knew that the quarterly certifications that he signed (and the representations therein)

would be used by GSI in preparing its financial statements and would be provided to GSI's independent auditor in connection with the quarterly reviews of GSI's financial statements.

17. On March 20, 2008 GSI's corporate controller emailed DiSessa and others asking whether there existed a factory automation issue with respect to the Taiwanese customer. In response, DiSessa told the corporate controller that GSI owed the customer "Phase II" factory automation software, which GSI hoped to complete by the second quarter of 2008. DiSessa provided the corporate controller with a copy of the TAS, which he stated contained the Phase II factory automation specifications.

18. During the fourth quarter of 2007, GSI recorded in its books and records and reported in its financial statements filed with the Commission nearly $5 million in revenue from sales to the Taiwanese customer. However, GSI should not have recognized any revenue from this transaction during this period because GSI had not delivered the customized, factory automation software required under the customer agreement.

Impact on Financial Statements

19. The misleading financial information that resulted from the improper recognition of revenue from the Korean and Taiwanese transactions was material because it (1) overstated revenues by 7.1% in the fourth quarter of 2007, by 1.6% for fiscal year 2007, 14.7% in the first quarter of 2008, and by 12.1% in the second quarter of 2008; and (2) overstated revenues for GSI's Systems Division by 21.5% in the fourth quarter of 2007, by 4.3% during fiscal year 2007, by 39.3% in the first quarter of 2008, and by 48.0% in the second quarter of 2008.[3]

20. As a result of the conduct described above, GSI's Form 10-K for the company's fiscal year 2007, as well as the Forms 10-Q for the quarters ended March 31, 2008 and June 30, 2008, contained false and misleading statements concerning GSI's financial results. For those two quarterly periods in 2008, GSI issued press releases, subsequently filed with the Commission on Forms 8-K, containing the false and misleading financial information.

## Violations

21. As a result of the conduct above, DiSessa willfully[4] committed violations of Section 13(b)(5) of the Exchange Act, which prohibits persons from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account as described in Section 13(b)(2) of the Exchange Act.

3 GSI also overstated pre-tax income by $1.4 million (6.4%) for fiscal year 2007, $3.6 million (5,206.0%) for the first quarter of 2008, and $2.9 million (1,443.1%) for the second quarter of 2008 as a result of the improper revenue recognition for the Korean and Taiwanese transactions.

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

22. Also as a result of the conduct above, DiSessa caused GSI's violations of Section 13(b)(2)(A) of the Exchange Act, which requires all reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and disposition of their assets.

23. Also as a result of the conduct above, DiSessa caused GSI's violations of Section 13(b)(2)(B) of the Exchange Act, which 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 conformity with generally accepted accounting principles.

24. Also as a result of the conduct above, DiSessa committed violations of Rule 13b2-1 of the Exchange Act, which prohibits any person from falsifying, or causing to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act.

25. Lastly, as a result of the conduct above, DiSessa caused GSI's violations of Sections 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents, and annual, quarterly and other 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.

## IV.

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

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

A. Respondent DiSessa cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Rules 12b-20, 13b2-1, 13a-1, 13a-11, and 13a-13 thereunder.

B. IT IS FURTHER ORDERED that Respondent shall pay a civil money penalty in the amount of $25,000 and disgorgement of $10,140 plus prejudgment interest of $1,370, for a total payment of $36,510, to the United States Treasury. DiSessa shall pay $10,000 within 10 days of entry of this Order, and shall pay the remaining $26,510 in installments of $8,255 within 180 days, $8,255 within 270 days, and $10,000 within 364 days of 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 disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. 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 Street, NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Peter DiSessa as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John T. Dugan, Associate Regional Director, Boston Regional Office, Securities and Exchange Commission, 33 Arch Street, 23rd Floor, Boston, Massachusetts 02110-1424.

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. 64498 / May 13, 2011**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3283 / May 13, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14386**

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|---|---|
| **In the Matter of**<br><br>**GSI GROUP, INC.,**<br><br>**Respondent.** | **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 that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against GSI Group, Inc. ("GSI" or "Respondent").

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 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 Respondent's Offer, the Commission finds that:[1]

### Summary

1. From at least 2004 through at least June 2008 (the "Relevant Period"), GSI improperly recognized revenue on certain transactions even though revenue recognition was prohibited pursuant to generally accepted accounting principles ("GAAP"). The improper revenue recognition resulted in part from a deficient system of internal controls that included no clear procedures to determine what deliverables the company owed its customers and whether it had met those deliverables, along with a lack of understanding of the relevant accounting principles among key employees. In addition, for at least two material transactions that occurred in 2007 and 2008, certain GSI employees engaged in misconduct by causing GSI to recognize revenue when they knew or should have known that the revenue should not have been recognized. As a result, GSI overstated revenues by a total of approximately $1.9 million or 0.7% in 2004, $3.5 million, or 1.4%, in 2005; $43.1 million, or 16.6%, in 2006; $15.0 million, or 5.0%, in 2007 (including by $16.1 million, or 23.9%, for the fourth quarter of 2007); and by approximately $7.8 million (12.7%) and $3.3 million (5.6%) during the first and second quarter of 2008.[2]

### Respondent

2. **GSI**, a New Brunswick, Canada corporation with its principal place of business in Bedford, Massachusetts, manufactures and sells laser systems and other technology products. GSI's stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and traded on the NASDAQ National Market System until July 31, 2006. From July 31, 2006 until April 15, 2010, GSI's stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the NASDAQ Global Market. On April 15, 2010, GSI's stock was delisted from the NASDAQ Global Market because it was delinquent in its Commission filings, deregistered from Section 12(b) of the Exchange Act, and reverted back to its designation under Section 12(g) of the Exchange Act. On November 20, 2009, GSI filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code in the U.S. Bankruptcy Court for the District of Delaware. On May 27, 2010, the U.S. Bankruptcy Court for the District of Delaware confirmed GSI's plan for reorganization. On July 23, 2010, GSI completed a rights offering and emerged from the Chapter 11 proceeding. On December 4, 2008, GSI announced that past financial statements filed with the Commission could no longer be relied upon due to errors discovered with GSI's recognition of revenue for those periods. On April 13, 2010, GSI filed restated annual and quarterly financial statements for the periods contained within the fiscal years 2004, 2005, 2006, 2007, and 2008. Effective February 14, 2011, GSI re-registered its common stock pursuant to Section 12(b) of the Exchange Act and is currently listed on the Nasdaq Global Select Market.

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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.

[2] Percentages are calculated based on restated revenues less discontinued operations.

## Facts

Background

3. During the Relevant Period, GSI's Systems Division manufactured production systems that it sold to both domestic and international customers. GSI's production systems generally had both hardware (including lasers) and software components (including, in certain instances, customized, vendor specific, factory automation software) and required on-site installation by GSI personnel.

4. From at least 2004 to mid-2007, the division controller for the Systems Division made the determination when to recognize revenue from Systems Division sales. In mid-2007, pursuant to a reorganization of GSI's finance department (the "Finance Department"), GSI's corporate controller, assisted by an assistant corporate controller, took over the revenue recognition determination for the Systems Division.

5. During the Relevant Period, Systems Division sales staff documented the basic terms of a transaction in a Sales Order Approval Form ("Sales Order Form") which, along with other documents associated with the transaction, were to be collected by the Systems Division's sales order administration personnel. Before booking an order, the documents were to be reviewed and, depending on the size of the order, approved by varying levels of sales, finance and management staff. Transactions generally were automatically recognized as revenue upon shipment. Prior to the close of the quarter, the Finance Department reviewed the documents related to each transaction and determined whether to recognize or defer any revenue.

Internal Control Deficiencies

6. During the Relevant Period, GSI had numerous deficiencies throughout its system of internal controls that were attributable, in part, to its failure to understand and assess the risks in the control environment and to design and execute monitoring procedures that evaluated the controls over those risks. Among other things, Systems Division personnel did not communicate well with Finance Department employees, a problem that worsened after the mid-2007 reorganization. Accordingly, Finance Department employees often had difficulty getting information from Systems Division employees.

7. The structure of the revenue recognition process did not ensure proper communication of transaction terms to the Finance Department. For example, sales representatives agreed to provide additional items to customers after the company received a purchase order, or offered customers other incentives, but frequently failed to properly document or communicate those agreements to the Finance Department. Because the Systems Division did not have any clear process to ensure that any concessions, upgrades, or other terms agreed to in the period between booking and recognizing revenue from a transaction were included with the transaction documents, the Finance Department was often unaware of the actual transaction terms. Both the additional items and the incentives frequently impacted the timing of revenue

recognition because the Finance Department often relied on incomplete information when making the revenue recognition decisions.

8. In addition, key sales and Finance Department employees did not sufficiently understand the relevant accounting rules applicable to the multi-element arrangements. The corporate controller did not apply those accounting rules correctly, and he failed to apply proper oversight over other employees involved in revenue recognition decisions.

The Korean Transaction

9. During November 2007, a Korean customer agreed to purchase from GSI ten systems for nearly $1 million per system. Each system was equipped with a laser previously sold by GSI. GSI agreed to upgrade these systems by replacing the original lasers with a laser that had not yet been developed (the "Undeveloped Laser") when it became available.[3] As a final condition, the customer demanded that GSI upgrade five systems that the customer had previously purchased with Undeveloped Lasers once they became available.

10. In November 2007, one of GSI's product line managers (the "PLM") sent a letter to the Korean customer confirming GSI's obligation to upgrade the five systems with Undeveloped Lasers. The PLM did not copy anyone on the letter, and neither the letter nor the terms therein were provided to the Finance Department. The PLM completed the sales order approval form for the transaction representing, among other things, that GSI had not made any "promises or guarantees for future deliverables (systems improvements, software upgrades, etc)." The PLM also signed a quarterly certification for the Finance Department stating that he was unaware of any side transactions or contingencies. The PLM knew or should have known that this certification (and the representations therein) would be used by GSI in preparing its financial statements and would be provided to GSI's independent auditor in connection with the quarterly reviews of GSI's financial statements.

11. In December 2007, the PLM, members of the Finance Department staff, and the the general manager of the Systems Division (the "Systems GM") met to discuss whether they could establish vendor specific objective evidence of value or fair value for the Undeveloped Lasers and thus recognize revenue from the transaction. During these discussions, they concluded that GSI could establish fair value for the Undeveloped Laser if they could find a substantially similar laser that GSI had previously sold. Shortly thereafter, the PLM and others identified a laser (the "Identified Laser") as being substantially similar to the Undeveloped Laser.

12. In fact, the Identified Laser was not substantially similar to the Undeveloped Laser for the purposes of recognizing revenue. Among other things, the Undeveloped Laser was a unique, undeveloped product that had significantly different future application potential. In addition, on several occasions the PLM had communicated to the Finance Department and others that the Undeveloped Lasers were worth substantially more than the Identified Laser.

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[3] During this period, GSI had two undeveloped lasers – a Multiple Pulse Infrared Laser and a Multiple Pulse Green Laser – that were to be upgraded in the production systems ordered by the Korean customer during 2007 and 2008. Neither of the lasers were substantially similar to the original lasers in the production system and, for the purposes of this Order, will be referred to collectively as the Undeveloped Laser(s).

13. On December 20, 2007, the corporate controller emailed the PLM a draft of a memo (the "Fair Value Memo") concluding that the Undeveloped Laser and the Identified Laser were substantially similar, which he asked the PLM to finalize and sign. The PLM, however, initially declined to sign the memo on the grounds that the lasers were different. The corporate controller then called the Systems GM and told him that if the PLM did not sign the memo, the company would not recognize revenue from the sale. The Systems GM indicated that he would talk to the PLM and, that same evening, the PLM emailed the corporate controller the signed Fair Value Memo. The PLM knew or should have known that this Fair Value Memo (and the representations therein) would be used by GSI in preparing its financial statements and would be provided to GSI's independent auditor in connection with the quarterly reviews of GSI's financial statements.

14. In the first and second quarters of 2008, the Korean customer ordered eight additional systems and corresponding upgrades for Undeveloped Lasers. The PLM signed another memo (to which the Fair Value Memo was attached) representing that the Undeveloped Laser to be used in these systems was substantially similar to the Identified Laser when in fact the lasers were not substantially similar. As a result, the Finance Department again used the Fair Value Memo to improperly recognize revenue for the systems.

15. During the first and second quarter of 2008, GSI recorded in its books and records and reported in its financial statements filed with the Commission over \$8.9 million and \$7.1 million in revenue, respectively, from the transactions with the Korean customer. However, GSI should not have recognized any revenue from these transactions during these periods because GSI had not delivered the Undeveloped Lasers, nor had it properly established fair value for the Undeveloped Laser in accordance with GAAP.

The Taiwanese Transaction

16. In or around January 2007, the PLM began negotiating a sale of six systems to a Taiwanese customer. The initial quotation specifically referenced a Tool Automation Specifications ("TAS") Agreement that related to the customer specifications or factory automation software that GSI would be obligated to provide.

17. During this same time, the primary engineer responsible for creating the factory automation software informed the PLM that implementing all the TAS specifications would be "a huge task," requiring over an additional 2000 hours of labor, would cost between \$450,000 to \$600,000, and could "not possibly be accomplished in the required time frame."

18. In March 2007, the Taiwanese customer ordered the six systems and specifically referenced compliance with the TAS as part of the arrangement. The PLM never informed the Finance Department that, as part of the transaction, the customer required customized software that would not be completed until several months after the systems had been installed and were operational. GSI booked the order and, between May and October 2007, shipped the six systems.

19. In late September 2007, the GSI's Finance Department told the PLM and other Systems Division personnel that GSI could not agree to any upgrades, contingencies, or future deliverables if it wished to recognize the revenue from the transaction. The PLM responded with an email specifically stating that "there are NO upgrades or contingencies," even though he knew that GSI had agreed to provide the customer with unique, customized software. The PLM also signed a quarterly certification stating that he was unaware of any contingencies or side agreements. When the customer accepted the first system during the fourth quarter of 2007, GSI recognized nearly $5 million in revenue from the six systems that had shipped, even though GSI still owed the customer the customized software. Because GSI had not delivered the customized software, and because it did not have fair value for the software, this revenue should not have been recognized at that time. The PLM knew or should have known that this certification (and the representations therein) would be used by GSI in preparing its financial statements and would be provided to GSI's independent auditor in connection with the quarterly reviews of GSI's financial statements.

20. On March 20, 2008 GSI's corporate controller emailed the PLM and others asking whether there existed a factory automation issue with respect to the Taiwanese customer. In response, the PLM told the corporate controller that GSI owed the customer "Phase II" factory automation, which GSI hoped to complete by the second quarter of 2008. The PLM provided the corporate controller with a copy of the TAS, which he stated contained the Phase II factory automation specifications.

21. In or around March 2008, the assistant corporate controller informed the corporate controller that the failure to provide factory automation may impact the revenue that GSI had previously recognized, which could result in a restatement. On April 3, 2008, the corporate controller emailed the assistant corporate controller, stating: "Please don't dig into these unless it blows up down the road. Let's work on getting things right going forward." On April 6, 2008, the corporate controller again emailed the assistant corporate controller: "When we go to the acceptance method this issue goes away. Let's dig into that once we get the quarter close behind us." The corporate controller did not properly investigate the matter and did not disclose the potential existence of undelivered factory automation software to the external auditors.

22. During the fourth quarter of 2007, GSI recorded in its books and records and reported in its financial statements filed with the Commission nearly $5 million in revenue from sales to the Taiwanese customer. However, GSI should not have recognized any revenue from this transaction during this period because GSI had not delivered the customized, factory automation software required under the customer agreement.

Impact on Financial Statements

23. As a result of the conduct described above, GSI overstated revenues by approximately $1.9 million (or 0.7%) in 2004, $3.5 million (1.4%) in 2005; $43.1 million (16.6%) in 2006; $15.0 million (5.0%) in 2007 (including by $16.1 million (23.9%) for the fourth quarter of 2007); and by approximately $7.8 million (12.7%) and $3.3 million (5.6%) during the first and second quarter of 2008, respectively.[4]

[4] Percentages are calculated based on restated revenues less discontinued operations.

24. The misleading financial information that resulted from the improper recognition of revenue from the Korean and Taiwanese transactions alone was material because it (1) overstated revenues by 7.1% in the fourth quarter of 2007, by 1.6% for fiscal year 2007, by 14.7% in the first quarter of 2008 and by 12.1% in the second quarter of 2008; and (2) overstated revenues for GSI's Systems Division by 21.5% in the fourth quarter of 2007, by 4.3% during fiscal year 2007, by 39.3% in the first quarter of 2008, and by 48.0% in the second quarter of 2008.[5]

25. As a result of the conduct described above, GSI's Form 10-K for the company's fiscal years 2004 through 2007, the Forms 10-Q for every quarter therein, as well as the Forms 10-Q for the quarters ended March 31, 2008 and June 30, 2008, contained false statements concerning GSI's financial results. For many of the quarterly periods described above, GSI issued press releases, subsequently filed with the Commission on Forms 8-K, containing the false and misleading financial information.

## Violations

26. As a result of the conduct described above, GSI violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20 thereunder, which 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.

27. As a result of the conduct described above, GSI violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and disposition of their assets.

28. As a result of the conduct described above, GSI violated Section 13(b)(2)(B) of the Exchange Act, which 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 conformity with generally accepted accounting principles.

## Remedial Efforts by GSI

29. In determining to accept GSI's Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

[5] GSI also overstated pre-tax income by $1.4 million (6.4%) for fiscal year 2007, $3.6 million (5,206.0%) for the first quarter of 2008, and $2.9 million (1,443.1%) for the second quarter of 2008 as a result of the improper revenue recognition for the Korean and Taiwanese transactions.

IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that Respondent GSI 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, 13a-1, 13a-11, and 13a-13 thereunder.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

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

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 202**

**[Release Nos. 33-9208 ; 34-64495 ; IC-29670 ]**

# Amendment to Procedures for Holding Funds in Dormant Filing Fee Accounts

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission is amending its procedures for holding funds in any filing fee account in which there has not been a deposit, withdrawal or other adjustment. The amendment extends the holding period from 180 days to three years, after which the Commission will initiate the return of funds to the account holder without any action by the account holder. As always, account holders may request a refund of such fees at any time.

**EFFECTIVE DATE:** [Insert date of publication in the Federal Register].

**FOR FURTHER INFORMATION CONTACT:** Kenneth Johnson, (202) 551-4306, Chief Financial Officer, Office of Financial Management; Stephen Jung, (202) 551-5162, Assistant General Counsel, Office of the General Counsel; Michael Bloise, (202) 551-5116, Senior Counsel, Office of the General Counsel, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

## SUPPLEMENTARY INFORMATION

The Commission is amending rule 3a (17 CFR 202.3a) of its Informal and Other Procedures under the Securities Act of 1933 ("Securities Act").[1]

[1] 15 U.S.C. 77a.

## I. Discussion

The federal securities laws impose a number of fees on filings.[2] Pursuant to rule 3a of the Commission's Informal and Other Procedures (17 CFR 202.3a), filing fees paid under the Securities Act, Exchange Act, and Investment Company Act currently are transmitted to a Treasury designated lockbox depository, where they are held in filing fee accounts maintained by the Commission for each filer who submits a filing requiring a fee on the Commission's EDGAR system or who submits funds to the Treasury designated lockbox depository in anticipation of paying a filing fee.[3] The Commission staff prepares account statements and sends these to account holders whenever a deposit, withdrawal, or other change occurs. The account holder, in turn, must maintain a current account address with the Commission to ensure timely access to such statements.[4] Pursuant to current 17 CFR 202.3a(e), the staff will initiate the return to the account holder of any funds held in any filing fee account in which there has not been a deposit, withdrawal or other adjustment for more than 180 calendar days, and account statements will not be sent again until a deposit, withdrawal or other adjustment is made with respect to the account.

The 180-day limitation on the time in which the Commission may hold such funds could lead to considerable inefficiency and administrative burden for both account holders and Commission staff. Increasing the length of time in which the funds may remain inactive in an account will allow greater flexibility to filers who still intend to pay

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2 See ,e.g., section 6(b) of the Securities Act, sections 13(e), 14(g), and 31 of the Securities Exchange Act of 1934 ("Exchange Act"), and section 24(f) of the Investment Company Act of 1940 ("Investment Company Act").

3 17 CFR 202.3a(d).

4 Id.

fees and do not want to receive a mandatory disbursement only to return it to the Commission at the time a fee is due. This concern is particularly acute for those filers whose payment obligations involve fees that are due on a periodic basis in excess of 180 days, such as investment companies who submit approximately 5,800 Form 24F-2 filings annually.[5] And, while the amendment will create more flexibility for filers who wish to leave funds in their accounts, the right of an account holder to receive a disbursement of excess funds from its account any time upon request to the Commission will continue unchanged.

The amendment also will harmonize the Commission's account-clearing procedure with Securities Act Rule 415(a)(5), which allows issuers eligible to conduct primary shelf offerings to sell securities relying on an effective registration statement for up to three years before they are required to file a new one.[6] This is particularly important in connection with automatic shelf registration statements, which allow issuers to register an indeterminate amount of securities when they initially file and defer payment of required fees until they later determine the amount of securities they wish to sell. As a result of this "pay-as-you-go" feature, issuers with automatic shelf registration statements may be required to pay additional fees throughout the life of the registration statement. Adoption of a three-year inactivity period before account balances are returned will ensure that funds paid at the time a shelf registration statement is initially filed will remain available to issuers in their lockbox accounts for the life of the registration statement. This could also benefit issuers by allowing them to review the

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[5] Form 24F-2 is the annual notice of securities sold by certain investment companies pursuant to rule 24f-2 under the Investment Company Act of 1940 that accompanies the payment of registration fees under the Securities Act of 1933.

[6] 17 CFR 230.415.

unused balances available in their lockbox accounts no more frequently than they are required to prepare and file new shelf registration statements. Issuers that review their capital-raising plans in connection with each required renewal of a shelf registration statement would be able to adjust the amounts on deposit in their lockbox accounts to match their future offering plans. Any resulting additional deposits or withdrawal requests would result in account activity, which would obviate the need for a refund until the expiration of an additional three-year time period. As a consequence, a three-year time period could help reduce the number of refund payments made to issuers who would prefer to have funds remain in their lockboxes to cover anticipated future filing needs. And, as noted above, the right of an issuer to receive a disbursement of excess funds from its account at any time upon request to the Commission will continue unchanged.

## II. Administrative Procedure Act and Other Administrative Laws

The Commission has determined that this amendment to its rules relates solely to the agency's organization, procedure, or practice. Therefore, the provisions of the Administrative Procedure Act ("APA") regarding notice of proposed rulemaking and opportunity for public participation are not applicable.[7] For the same reasons, and because this amendment does not substantially affect the rights or obligations of non-agency parties, the provisions of the Small Business Regulatory Enforcement Fairness Act are not applicable.[8] In addition, the provisions of the Regulatory Flexibility Act, which apply only when notice and comment are required by the APA or other law, are

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[7] 5 U.S.C. 553(b).

[8] 5 U.S.C. 804.

not applicable.[9] Finally, this amendment does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended.[10]

## III. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. The rule amendment the Commission is adopting today amends the Commission's rules to extend the period in which the Commission shall hold funds in a dormant account prior to issuing an automatic refund, so as to increase the efficiency of the procedure and harmonize the Commission's account clearing procedures with Securities Act Rule 415(a)(5). The right of an account holder to receive a full refund of fees held by the Commission in a dormant account, at any time upon request, remains unchanged. The Commission does not believe that the rule amendment will impose any costs on non-agency parties, or that if there are any such costs, they are negligible.

## IV. Consideration of Burden on Competition

Section 23(a)(2) of the Exchange Act 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 Commission does not believe that the amendment that the Commission is adopting today will have any impact on competition.

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9 5 U.S.C. 601-12.

10 44 U.S.C. 3501-20.

## V. Statutory Basis and Text of Final Rule Amendments

The Commission is adopting amendments pursuant to sections 6(b) and 19 of the Securities Act, sections 13(e), 14(g), 23, and 31 of the Exchange Act, and sections 24(f) and 38 of the Investment Company Act. List of Subjects

17 CFR Part 202

Administrative practice and procedure, Securities.

In accordance with the foregoing, 17 CFR, Chapter II of the Code of Federal Regulations is amended as follows:

**PART 202- INFORMAL AND OTHER PROCEDURES**

1. The authority citation for Part 202 continues to read in part as follows:

**Authority:** 15 U.S.C. 77s, 77t, 78d–1, 78u, 78w, 78ll(d), 79r, 79t, 77sss, 77uuu, 80a–37, 80a–41, 80b–9, 80b–11, and 7201 et seq., unless otherwise noted.

* * * * *

2. Section 202.3a paragraph (e) is amended by removing the phrase "180 calendar days", and adding in its place the phrase "three years".

By the Commission.

Cathy H. Ahn
Deputy Secretary

Dated: May 13, 2011

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64500 / May 16, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3205 / May 16, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14387

In the Matter of

HEATH M. BIDDLECOME,

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 Heath M. Biddlecome ("Biddlecome" or "Respondent").

II.

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

## III.

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

1. Heath M. Biddlecome was the founder and president of California Wealth Management Group, d.b.a. IFC Advisory ("IFC Advisory"), an investment adviser registered with the Commission from June 2005 to November 2010. From November 2004 through March 2009, Biddlecome was also a registered representative associated with Purshe Kaplan Sterling Investments, a registered broker-dealer. Biddlecome, age 41, is a resident of Carpinteria, California.

2. On May 5, 2011, a final judgment was entered by consent against Biddlecome, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, and aiding and abetting violations of Section 204 of the Advisers Act, in the civil action entitled SEC v. Homestead Properties, L.P., et al., Civil Action Number SACV09-01331, in the United States District Court for the Central District of California, Southern Division.

3. The Commission's first amended complaint ("complaint") alleged that from June 2007 to at least November 2009, Biddlecome managed an investment fund, Homestead Properties, L.P. ("Homestead"), that raised over $9.8 million from 36 investors, including advisory clients and at least 33 investors who were between 60 and 97 years old at the time they invested. The complaint alleged that Homestead's private placement memorandum and partnership agreement (collectively, "offering materials") stated that Homestead would use investors' money for real property investments, specifically mobile home park communities. However, according to the complaint, in October 2008, Biddlecome transferred $4.5 million of investor funds into a brokerage account held in Homestead's name, and, immediately thereafter, Biddlecome engaged in speculative short term trading with the Homestead funds. The complaint further alleged that Biddlecome failed to inform investors that he had shifted investor funds into a brokerage account and engaged in a speculative short term trading strategy, and Homestead's offering materials do not give it the right to invest in anything other than real estate. The complaint also alleged that Biddlecome misrepresented that Homestead would engage an accounting firm to audit Homestead's books on a yearly basis, that Homestead would use a registered broker-dealer to sell interests in Homestead to investors, and that the source of investor distributions would originate or relate in some way to Homestead's accrued net profits. Instead, Homestead did not engage an auditing firm until two years after the offering began and no audit was ever completed, and Homestead did not sell interests through a broker-dealer and thus had no oversight or supervision of the offering from a broker-dealer. Homestead also had no accrued net profits, and thus paid investor distributions with money from investors' capital contributions. Lastly, the complaint alleged that Biddlecome sold unregistered securities, was not associated with a registered broker-dealer for purposes of selling the Homestead offering, and failed to produce certain requested records to the Commission's examination staff.

## IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Biddlecome 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, and from participating in any offering of penny stock, with the right to reapply for association after three years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating
Commissioner Paredes Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9209 / May 16, 2011

SECURITIES EXCHANGE ACT OF 1934
Release No. 64501 / May 16, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29672 / May 16, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14388

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| In the Matter of<br><br>ARMANDO RUIZ, and<br>MARADON HOLDINGS, LLC,<br><br>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 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), 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 Armando Ruiz ("Ruiz") and Maradon Holdings, LLC ("Maradon" and together with Ruiz, "Respondents").

## II.

After an investigation, the Division of Enforcement alleges that:

## SUMMARY OF ALLEGATIONS

1. This matter concerns an affinity fraud conducted by Ruiz through an offering of securities purportedly issued by Maradon, an entity that Ruiz controlled.

2. From April 2008 through May 2009, Ruiz raised approximately $817,500 from nine investors -- all of whom were either Ruiz's friends or family members -- by purporting to sell to them preferred shares or some other equity interest in Maradon. In addition to representing to the investors that they were purchasing an equity interest in Maradon, Ruiz told the investors that their funds would be used to help develop Maradon into a financial services firm serving the Hispanic community. Ruiz's representations were false and misleading because: (i) Maradon never issued stock or any form of equity interest to the investors; and (ii) Ruiz used the vast majority, if not virtually all, of the offering proceeds to pay personal expenses and trade stocks rather than fund the development of Maradon's business. Ruiz's misrepresentations were material, and Ruiz knew, or was at least reckless in not knowing, that his representations were false or misleading.

3. During the relevant period, Ruiz was, and still remains, a registered representative associated with Legend Securities, Inc. ("Legend"), a registered broker-dealer.

4. By virtue of this conduct, Ruiz willfully violated, and committed or caused violations of, Section 17(a) of the Securities Act, Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, and Maradon violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5.

## RESPONDENTS

5. **Maradon** is a Delaware limited liability company ("LLC") with a purported principal place of business in Rancho Santa Fe, California. According to Delaware filings, Elizabeth Ruiz, Ruiz's wife, organized Maradon in May 2007, but Elizabeth Ruiz appears to have had no role in Maradon's operations, which were controlled by Ruiz during the relevant period.

6. **Ruiz**, age 45, resides in Rancho Santa Fe, California. Ruiz is a registered representative and has been associated with Legend since June of 2008. He holds Series 7 and 63 licenses and has been a broker since 1988. Ruiz worked at Lehman Brothers until 1993 and then spent two years at Paine Webber. In 1998, he was censured by the New York Stock Exchange and had his securities licenses suspended for 15 months for unauthorized trading in customer accounts at Paine Webber. From 1995 through 2008, Ruiz was self-employed as a money manager. During part of that period, he operated a hedge fund named Armada Partners LP and the entity that managed that fund, Armada Management LLC. In December 2010, the bankruptcy trustee for Dreier LLP filed a lawsuit against Ruiz and the two Armada entities seeking to recover $13,529,250 in transfers made by the debtor between February 2006 and January 2008. *Gowan v. Armada Partners LP, Armada Management LLC and Armando Ruiz*, 10-054520-smb (Bankr. S.D.N.Y. Dec. 15, 2010).

## RELEVANT ENTITY

7. **Legend** is a New York corporation with its principal offices in New York, New York and multiple branch offices located in other states in the region. Legend has been a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act since 1998.

## THE RESPONDENTS' OFFERING FRAUD

### The Formation of Maradon

8. Maradon was formed as an LLC in May 2007. Maradon's organizational documents, including its LLC agreement, name Elizabeth Ruiz, Ruiz's wife, as the sole member and manager of Maradon. No change was ever made to the LLC agreement or any other relevant documents to add or substitute other individuals as members or managers of Maradon. Despite lacking actual authority to act on Maradon's behalf, Ruiz unilaterally opened bank accounts, signed contracts and otherwise exercised exclusive control over Maradon during the relevant period.

### Ruiz's Material Misrepresentations to Maradon Investors

9. Beginning in approximately April 2008, Ruiz began soliciting investments in Maradon. Eight individuals invested a total of $705,000 with Ruiz in 2008 and 2009, and a ninth investor made a loan of $112,500 to Maradon in 2009 that is convertible into equity.

10. While discussing investing in Maradon with these investors, Ruiz knowingly or recklessly misrepresented at least two material facts. First, Ruiz told the investors that they were purchasing an equity interest in Maradon, and he told some of them that the equity interest they were purchasing was preferred stock. Second, Ruiz told investors that Maradon was a start-up venture that he was seeking to develop into a financial services company serving the Hispanic community, thus representing that the funds which they invested would be used to finance those development efforts. The representations made by Ruiz were false, as Maradon never issued an equity or ownership interest of any kind to the investors and Ruiz freely used the offering proceeds to day-trade stocks and fund personal expenses. Ruiz knew, or was reckless in not knowing, that his representations were false, because he controlled all of Maradon's activities and spent all of the investor funds.

11. All of the investor funds were deposited into Maradon's bank accounts. Seven individuals, including two of the Maradon investors, also made purported loans to Ruiz and/or Maradon that totaled approximately $619,719. In each instance, the proceeds of these purported loans were wired directly to one of Maradon's two bank accounts and commingled with the funds that came from the investors who purportedly purchased an equity interest in Maradon.

**Maradon Did Not Issue Stock Or Any Other Equity Interest To The Investors**

12. Although Ruiz told all the investors that they would be owners of Maradon, none of the investors actually received the investment instrument that Ruiz told them they were purchasing. At least four of the nine investors received letters from Ruiz setting forth their agreement to purchase Maradon securities. Although Ruiz was the one who sent these letters to the investors, the letters were addressed to Ruiz, as "President" of "Maradon Holdings LLC," and read as if they came from the investors, with Ruiz counter-signing on behalf of Maradon. According to these letters, the investors were purchasing shares of "Series A Preferred Stock" of Maradon. That was plainly false, as Maradon was a Delaware LLC and, based on its LLC agreement and Delaware law, could not lawfully issue shares of preferred or any other form of stock. In fact, Maradon did not issue stock, equity or any other kind of ownership interest in Maradon to any of the investors.

13. Equity or ownership interests in an LLC -- *e.g.* an interest in a portion of the profits and losses of the LLC and a right to receive a distribution of LLC assets -- are in the form of membership interests, not stock. After formation of an LLC, a person can be admitted as a member of the LLC, and receive a membership interest in the LLC, only in the manner provided in the LLC agreement or, if the agreement does not so provide, upon the consent of all members and when the person's admission is reflected in the records of the LLC. Maradon's LLC agreement states as follows with respect to transfers of interests and the admission of additional members: "The Member shall be permitted to transfer all or any portion its interest in the [LLC]. One or more additional members may be admitted to the [LLC] with the consent of the Member."

14. Maradon did not issue membership interests to any of the investors in the manner described above or in any other legally effective manner. There is no record of any proper amendment to Maradon's organizational documents reflecting the addition of new members, which would require the managing member's approval. Ruiz's wife was and remains the sole member and manager of Maradon, and she did not execute any documents with respect to the issuance or conveyance of any interest of any kind in Maradon to the investors. Absent proper legal action by Ruiz's wife, an investor could not actually receive a membership interest. Ruiz knew while he was selling purported interests in Maradon that his wife had not taken any steps to approve the admission of new members, yet Ruiz continued to sell membership interests without disclosing to investors that the interests did not yet exist and that he lacked the authority to create them.

**Ruiz Misused Offering Proceeds To Fund Personal Expenses**

15. Rather than use investor funds to develop Maradon's purported business, Ruiz used the offering proceeds mostly to fund various personal expenses, notwithstanding his representations to investors that their investments were going to be used to fund the development of a Hispanic financial services firm.

16. In a document that Ruiz prepared and provided to at least one investor, Ruiz laid out the details of Maradon's purported business plan and touted its anticipated future

growth based on various planned initiatives. Among other relevant passages in this document, Ruiz made the following statements about Maradon's planned activities:

a. Maradon "is a new breed of financial services company that will capitalize on the 'Hispanization' of the United States by targeting the developing, but currently under-serviced, Hispanic financial services market."

b. Maradon "intends to capture revenue by not only servicing Hispanic individuals through its retail brokerage business, but by targeting private and public pension funds which invest with minority owned financial service providers."

c. "During this initial phase of development, Maradon is in the process of opening individual retail brokerage accounts with a primarily Hispanic clientele. During this startup phase, these accounts are maintained at an existing broker dealer. However, within the next [eight to twelve months], Maradon intends to raise sufficient capital to either form its own broker-dealer or purchase an existing broker dealer through which to service its clients."

d. "In its second phase of development, Maradon will also target private and public pension funds that are seeking minority financial services providers to service their funds."

e. "Given Maradon's breadth of experience in the financial markets and its commitment and uncommon access to the Hispanic community, pursuing private and public pension funds as a source of revenue is a natural compliment [sic] to its retail brokerage business."

17. Ruiz also made similar statements about Maradon's business plan in his conversations with investors. He told them, among other things, that Maradon was a start-up company that was going to be a broker-dealer and investment advisory firm serving the Hispanic community with the goals of giving Spanish-speaking investors an understanding of how the markets work and providing financial services to them. Ruiz also told investors that Maradon would use their money to fund start-up expenses, build the business and attract other investors.

18. In fact, Maradon did not engage in, or take any meaningful steps towards engaging in, any of the business activities described above. Nevertheless, of the over $1.5 million that Ruiz obtained from those who invested in Maradon and those who purportedly loaned money to him and/or Maradon, there was little more than $1,000 left in Maradon's bank accounts as of June 30, 2009. Ruiz used the vast majority, if not virtually all, of the investors' money to engage unsuccessfully in high risk "day-trading" of stocks, pay personal expenses or make other, unexplained expenditures that have no connection to Maradon's purported start-up business activities.

19. Ruiz had exclusive control over both of Maradon's bank accounts, into which all the investor funds were deposited. Ruiz's expenditures of Maradon funds included the following:

a. Ruiz wired a total of $504,000 to brokerage accounts that he controlled at three broker-dealer firms. Ruiz engaged in day-trading through these accounts, and lost all of these funds.

b. Ruiz wired a total of $121,250 to pay rent on Ruiz's personal residence in Rancho Santa Fe, California, where the monthly rent is $10,250 on a 5,554 square foot home that is currently valued at $2.6 million on zillow.com.

c. Ruiz wired approximately $169,000 to a friend with no connection to Maradon and who operated a ticket brokerage business in New York.

d. Ruiz spent over $100,000 on travel, including plane tickets and stays at hotels, resorts and casinos in California, New York, Puerto Rico, Florida and Las Vegas.

e. Debit card transactions where the payee is identified indicate that Ruiz spent approximately $40,000 on clothing, groceries, furniture, sporting events, and other retail expenses.

f. Ruiz made over $18,000 in debit card payments at restaurants in New York City, Miami and San Diego, including 6 separate occasions when the charges exceeded $500.

g. Ruiz withdrew approximately $1,000 in ATM transactions at southern California racetracks.

h. Ruiz made approximately $500,000 in additional cash withdrawals, with no indication of how the funds were spent.

20. Additional expenses for which Ruiz used Maradon funds included: (i) approximately $25,000 for legal services, with $14,000 going to a Florida firm that represented Ruiz's wife in her bankruptcy case; (ii) $12,000 for insurance, including $9,350 to a life insurance company; (iii) $10,000 for utilities, including payments to the municipal water district in which Ruiz's residence is located, to a San Diego electric company and to a cable television company; and (iv) $5,000 for medical and related expenses.

21. Ruiz also made approximately $30,000 in rent payments on office space leased by Maradon in Rancho Santa Fe, California, but Maradon's lease was terminated in August 2009 for non-payment of rent. Ruiz paid monthly rent of $3,944 on Maradon's one-year lease for seven months beginning in August 2008, but he stopped paying the rent after April 2009. Ruiz also spent approximately $7,400 on office supplies. In sworn

testimony given in connection with the Commission staff's investigation in this matter, Ruiz did not identify any start-up business activities in which he purportedly engaged on Maradon's behalf other than conducting "research" into "cultural nuances" within the Hispanic community.

22. When soliciting investors for Maradon, Ruiz did not disclose that he would be using the invested funds to day-trade or otherwise trade stocks, whether for his own account or for Maradon's account, and to finance his own extravagant personal living, travel and entertainment expenses. Ruiz had already begun using investor funds for these purposes while continuing to solicit additional investors.

23. In October 2009, six of Maradon's nine investors were repaid the amount of their investment. The amounts refunded to these six investors totaled $180,000. Each of these investors received a letter from Maradon, signed by its purported new "Managing Member, Chief Executive and President." The letter stated, among other things, that Ruiz had commingled investor funds with his own funds and had used investor funds to pay for personal expenses, as follows: "The problem is that Armando used his money, my money, your money, etc without separating Maradon's trading, its costs and expenses from his own." In sworn testimony given in connection with the Commission staff's investigation in this matter, Ruiz testified that this statement was true and that he had used investor funds to pay personal expenses because he "didn't think of the [investor funds] as not my stuff."

## VIOLATIONS

24. As a result of the conduct described above, Ruiz willfully violated, and committed and caused Maradon's 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.

25. As a result of the conduct described above, Ruiz willfully violated Section 15(a) of the Exchange Act, which prohibits a broker or dealer from effecting transactions in, or inducing or attempting to induce the purchase or sale of, any security unless such broker or dealer is registered with the Commission.

26. As a result of the conduct described above, Maradon 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.

## 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 Ruiz 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 Ruiz pursuant to Section 9(b) of the Investment Company Act, including, but not limited to, disgorgement and civil penalties pursuant to Sections 9(d) and (e) of the Investment Company Act; and

D. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, the 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) of the Exchange Act and Rule 10-5 thereunder; whether the Respondents should be ordered to pay civil monetary penalties pursuant to Section 8A(g) of the Securities Act and Section 21B(a) of the Exchange Act; and whether the Respondents should be ordered to pay disgorgement, plus prejudgment interest, pursuant to Section 8A(e) of the Securities Act and Sections 21B(e) and 21C(e) of the Exchange Act.

## IV.

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

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

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

This Order shall be served forthwith upon 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. 64502 / May 16, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14389**

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| **In the Matter of**<br><br>**LEGEND SECURITIES, INC. and SALVATORE CARUSO,**<br><br>**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 Legend Securities, Inc. and Salvatore Caruso (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

**Respondents**

1. **Legend Securities, Inc.** ("Legend"), is a New York corporation with its principal office in New York, New York and multiple branch offices located in other states in the region. Legend has been a broker dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act since 1998.

2. **Salvatore Caruso** ("Caruso"), age 42, resides in Staten Island, New York. Since he co-founded the firm in 1998, Caruso has served as its President and Chief Compliance Officer, among other titles, and as a registered representative. Caruso holds Series 4, 7, 24, 27, 53 and 63 securities licenses.

**Facts**

3. On March 24, 2009, staff with the New York Regional Office's broker dealer inspection program ("BDIP Staff") commenced an examination of Legend. In connection with the examination, BDIP Staff requested that Legend provide various records, including certain records concerning Legend employees. Caruso produced the documents on Legend's behalf in response to the examination staff's request. The records produced by Caruso did not include certain requested documents for one associated person of Legend (the "Associated Person").

4. On May 4, 2009, BDIP Staff requested the personnel file for the Associated Person. After not receiving any documents in response, BDIP Staff reiterated this request on multiple occasions between May 4 and May 22, 2009.

5. On May 26, 2009, Caruso sent the Associated Person an electronic mail message in which Caruso wrote:

> I'm going thru (sic) my employee files for the SEC audit and realized that I don't have all of the other employment/registration forms for you. I only have your form U4. I have attached the forms that I need you to complete, sign and fax back to me ASAP. Please date the forms 06-09-2008. It's very important.

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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.

Attached to this email message were seven documents related to the Associated Person's relationship with Legend, including his independent contractor agreement, commission schedule, and compliance forms.

6. The Associated Person complied with Caruso's request. The date that Caruso directed the Associated Person to use when signing the documents, June 9, 2008, corresponded to the date the Associated Person became a registered representative at Legend.

7. On June 2, 2009, Caruso provided the Associated Person's personnel file, including all the documents that the Associated Person had signed the previous week, to the BDIP Staff. Caruso did not disclose to the BDIP Staff the circumstances surrounding the back-dating of the documents.

8. As a result of the foregoing, Legend failed to make and keep current, true and complete records of all agreements between it and the Associated Person and also failed to furnish promptly such records when requested to do so by the BDIP staff.

9. As a result of the conduct described above, Legend willfully violated Section 17(a) and Rules 17a-3 and 17a-4 of the Exchange Act. Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder require that brokers or dealers make and keep current various records relating to its business and preserve those records for specified periods of time. Specifically, Rule 17a-3(a)(19)(ii) requires registered brokers and dealers to make and keep current records "of all agreements pertaining to the relationship between each associated person" and the broker or dealer. Rule 17a-4(j) requires broker-dealers to "furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records" of the broker or dealer that are required to be preserved under Section 17(a) or "any other records" of the broker or dealer that are "subject to examination under Section 17(b) of the [Exchange] Act that are requested by the representative of the Commission." Legend failed to make and keep current records concerning its relationship with the Associated Person. Specifically, Legend failed to make and keep current records related to the Associated Person's employment and compensation. Legend also failed to furnish promptly true, complete and current copies of such records when requested to do so by representatives of the Commission.

10. As a result of the conduct described above, Caruso willfully aided and abetted and caused Legend's violation of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder.

## 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 Legend cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder;

B. Respondent Caruso cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder; and

C. Respondents Legend and Caruso are censured.

D. Legend and Caruso shall, within thirty (30) days of the entry of this Order, pay civil money penalties to the United States Treasury in the following amounts: Legend shall pay $50,000 and Caruso shall pay $25,000. If timely payment of the full amount is not made by either Respondent, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, 100 F Street NE, Mail Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Legend Securities, Inc. and Salvatore Caruso as the Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Rosenfeld, Associate Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281.

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. 64504 / May 16, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14391

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| **In the Matter of**<br><br>**Dechtar Direct Inc.,**<br>**DigitalReach Holdings, Inc. (n/k/a People Dynamics Holdings, Inc.),**<br>**Dippy Foods, Inc.,**<br>**DLD Group, Inc.,**<br>**DNA Plant Technology Corp.,**<br>**Docplanet.com, Inc.,**<br>**Docugraphix, Inc., and**<br>**DTC Data Technology Corp.,**<br><br>**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 Dechtar Direct Inc., DigitalReach Holdings, Inc. (n/k/a People Dynamics Holdings, Inc.), Dippy Foods, Inc., DLD Group, Inc., DNA Plant Technology Corp., Docplanet.com, Inc., Docugraphix, Inc., and DTC Data Technology Corp.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Dechtar Direct Inc. (CIK No. 1008850) is a suspended California corporation located in San Francisco, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Dechtar Direct 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, 1997, which reported a net loss of over $482,000 for the prior nine months. On August 24, 1998, Dechtar Direct filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of California, and the case was terminated on March 1, 2007.

2. DigitalReach Holdings, Inc. (n/k/a People Dynamics Holdings, Inc.) (CIK No. 1145006) is a dissolved Florida corporation located in Van Nuys, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DigitalReach Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic filings since it filed a Form 10-QSB for the period ended March 31, 2002, which reported a net loss of over $96,000 for the prior three months.

3. Dippy Foods, Inc. (CIK No. 1080033) is a permanently revoked Nevada corporation located in Cypress, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Dippy Foods 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, 2002, which reported a net loss of over $533,000 for the prior nine months. As of May 16, 2011, the company's stock (symbol "DPPI") was traded on the over-the-counter markets.

4. DLD Group, Inc. (CIK No. 1114815) is a void Delaware corporation located in Pasadena, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DLD Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended October 31, 2001, which reported a net loss of over $26,000 for the prior six months.

5. DNA Plant Technology Corp. (CIK No. 730985) is a Delaware corporation located in Oakland, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DNA Plant Technology 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, 1996, which reported a net loss of over $5.2 million for the prior six months.

6. Docplanet.com, Inc. (CIK No. 312651) is a delinquent Colorado corporation located in Santa Ana, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Docplanet.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended May 31, 2000, which reported a net loss of over $8.1 million for the prior nine months.

7. Docugraphix, Inc. (CIK No. 768841) is a suspended California corporation located in Ramona, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Docugraphix 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, 1994, which reported a net loss of over $551,000 for the prior nine months.

8. DTC Data Technology Corp. (CIK No. 812544) is a dissolved Delaware corporation located in Milpitas, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DTC Data Technology is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 1995, which reported a net loss of over $2.5 million 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.

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
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. 64505 / May 16, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14392**

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| **In the Matter of**<br><br>**Saf T Lok, Inc., Salesrepcentral.com, Inc., Sames Corp., Scientific Radio Systems, Inc., Scriptel Holding, Inc. (n/k/a National Community Builders, Inc.), SDC International, Inc., and Seneca Acquisition Corp.,**<br><br>**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 Saf T Lok, Inc., Salesrepcentral.com, Inc., Sames Corp., Scientific Radio Systems, Inc., Scriptel Holding, Inc. (n/k/a National Community Builders, Inc.), SDC International, Inc., and Seneca Acquisition Corp.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Saf T Lok, Inc. (CIK No. 902056) is a dissolved Florida corporation located in Sharon, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Saf T Lok 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 $80,000 for the prior

three months. On May 22, 2002, Saf T Lok filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Pennsylvania, and the case was terminated on September 8, 2006.

2. Salesrepcentral.com, Inc. (CIK No. 1069559) is a Nevada corporation located in Oldsmar, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Salesrepcentral.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002.

3. Sames Corp. (CIK No. 12180) is a forfeited Delaware corporation located in Franklin Park, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sames 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, 2001, which reported a net loss of over $1.7 million for the prior three months. On August 17, 2001, Sames filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Illinois, and the case was terminated on February 11, 2011.

4. Scientific Radio Systems, Inc. (CIK No. 87817) is a dissolved New York corporation located in Rochester, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Scientific Radio 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 March 31, 1993, which reported a net loss of over $445,000 for the prior nine months. On February 2, 1995, Scientific Radio filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of New York, and the case was terminated on January 17, 1996.

5. Scriptel Holding, Inc. (n/k/a National Community Builders, Inc.) (CIK No. 830504) is a Delaware corporation located in Columbus, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Scriptel Holding 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, 1997, which reported a net loss of over $1 million for the prior three months.

6. SDC International, Inc. (CIK No. 1005841) is a void Delaware corporation located in Palm Beach, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SDC International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB/A for the period ended December 31, 2001, which reported a net loss of over $9.9 million for the prior twelve months.

7. Seneca Acquisition Corp. (CIK No. 1120643) is a permanently revoked Nevada corporation located in Jenkintown, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Seneca Acquisition is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended July 26, 2001.

B. DELINQUENT PERIODIC FILINGS

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

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

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

**III.**

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

A. Whether the allegations contained in Section II 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. 64513 / May 18, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14397**

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| **In the Matter of**<br><br>**Lowell Gene "Bob" Hancher,**<br><br>**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 Lowell Gene "Bob" Hancher ("Hancher").

**II.**

In anticipation of the institution of these proceedings, Respondent Hancher 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 Hancher 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 Hancher's Offer, the Commission finds that:

1. Hancher, age 57, is a resident of Sheridan, Indiana. In 2000, Hancher founded Commerce Street Venture Group, Inc. ("Commerce Street"), an Indiana merger broker, and served as its Chief Executive Officer until it ceased operations in February 2010. Hancher also has served on the boards of directors of several penny stock companies, including the boards of Cycle Country Accessories Corporation ("Cycle Country") and LMWW Holdings, Inc. ("LMWW"). Hancher became

a member of Cycle Country's board of directors in 2001 and served as the board and audit committee chairman from September 2009 until his resignation in January 2010.

2. On January 25, 2011, a final judgment was entered by consent against Respondent Hancher permanently enjoining him from future violations or aiding and abetting violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b), 13(a), 13(b)(5) and 15(a)(1) of the Exchange Act and Rules 10b-5, 12b-20, 13a-13, 13b2-1 and 13b2-2 thereunder in a civil action entitled U.S. Securities and Exchange Commission v. Lowell Gene "Bob" Hancher, et al., Civil Action Number 5:11-cv-04005-MWB in the United States District Court for the Northern District of Iowa, Western Division.

3. The Commission's complaint alleged that, between April 2005 and November 2007, Hancher, working through Commerce Street, raised more than $1.8 million from at least 60 investors in connection with a fraudulent stock offering for Scott Contracting, Inc., a Colorado construction company. Hancher told different investors at least four inconsistent lies about how their money would be invested and promised them outsized returns of 50% and instead misappropriated all of the funds he raised and used them to pay personal and business expenses. In a second scheme, between December 2007 and February 2008, Hancher directed others to place manipulative matched orders for more than 60,000 shares of LMWW stock in order to prop up its stock price and increase its trading volume. In a third scheme, between September 2008 and January 2010, Hancher abused his position with Cycle Country to misappropriate $507,500 from the company under the guise of taking Cycle Country private through a stock buyback. To cover-up his scheme, Hancher created numerous fake documents and lied to Cycle Country's external auditor.

**IV.**

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act that Respondent Hancher 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 application for re-entry by the Respondent will be subject to the applicable laws and regulations governing the re-entry process, and re-entry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 200**

**[Release No. PA-45; File No. S7-19-11]**

**Privacy Act of 1974: Implementation and Amendment of Exemptions**

**AGENCY**: Securities and Exchange Commission.

**ACTION**: Proposed rule.

**SUMMARY:** Pursuant to the Privacy Act of 1974, as amended, the Securities and Exchange Commission ("Commission" or "SEC") proposes to exempt portions of three new systems of records from provisions of the Privacy Act to the extent that the records contain investigatory materials compiled for law enforcement purposes. Additionally, the Commission proposes to make technical amendments to its Privacy Act regulation exempting specific systems of records from certain provisions of the Privacy Act. In a companion release published elsewhere in this issue, the Commission is giving concurrent notice of three new systems of records pursuant to the Privacy Act of 1974.

**DATES**: Comments must be received on or before [insert date 30 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-19-11 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, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number S7-19-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.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 available publicly.

**FOR FURTHER INFORMATION CONTACT:** Cristal Perpignan, Acting Chief Privacy Officer, Office of Information Technology, 202-551-7716.

**SUPPLEMENTARY INFORMATION:**

Pursuant to, and limited by 5 U.S.C. 552a(k)(2), the Commission proposes to exempt systems of records, "Tips, Complaints, and Referrals (TCR) Records (SEC-63)"; "SEC Security in the Workplace Incident Records (SEC-64)"; and "Investor Response Information System (IRIS) (SEC-65)", from 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) and 17 CFR 200.303, 200.304, and 200.306, insofar as they contain investigatory materials compiled for law enforcement purposes. The Privacy Act allows Government agencies to exempt certain records from the notification, access and amendment provisions. If an agency claims an exemption, however, it must issue a rule to explain the reasons why a particular exemption is claimed. The proposed exemption would be applicable except under the circumstances set forth in the provisions of section (k)(2) of the Privacy Act.[1]

The TCR Records (SEC-63) system of records contains records related to tips, complaints, referrals of misconduct, or related information about actual or potential violations of the federal securities laws; investor harm; conduct of public companies; securities professionals; regulated entities; and associated persons. This system of records may include investigatory materials that were compiled in connection with the Commission's enforcement responsibilities under the federal securities laws. Such material may consist of unsolicited and often unverified statements concerning individuals, information received from confidential sources, as well as reports from the Commission's investigators and other law enforcement personnel. The disclosure of the existence of investigatory materials could seriously undermine effective enforcement of the federal securities laws by prematurely alerting individuals to the fact that they are under investigation, by giving them access to the evidentiary bases for a Commission enforcement action or seriously hampering the Commission's case in court or before an administrative law judge.

The SEC Security in the Workplace Incident Records (SEC-64) system of records contains records related to reports involving incidents of assault, harassment, intimidation, bullying, weapons possession, or threats at the SEC. This system of records may include investigatory materials that were compiled in connection with inquiries or investigation of potential or actual incidents of violence by and against individuals at an SEC facility. The disclosure of information as it relates to investigatory materials or the identity of sources of information may seriously undermine the safety and security of employees in the workplace.

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1 See 5 U.S.C. 552a(k)(2).

Access to such information could allow the subject of an investigation or inquiry of an actual or potential criminal or civil violation to interfere with and impede the investigation, tamper with witnesses or evidence, and to avoid detection or apprehension.

The IRIS (SEC-65) system of records contains records related to complaints/inquiries/requests from members of the public and others. This system of records may include investigatory materials that were compiled in connection with the Commission's enforcement responsibilities under the federal securities laws. Such material may consist of unsolicited and often unverified statements concerning individuals, information received from confidential sources, as well as reports from the Commission's investigators and other law enforcement personnel. The disclosure of the existence of investigatory materials could seriously undermine effective enforcement of the federal securities laws by prematurely alerting individuals to the fact that they are under investigation, by giving them access to the evidentiary bases for a commission enforcement action or seriously hampering the Commission's case in court or before an administrative law judge.

The Commission also proposes to amend its inventory of exempted systems of records by changing the name of the system of records titled: "Office of Personnel Code of Conduct and Employee Performance Files (SEC-38)" to "Disciplinary and Adverse Actions, Employee Conduct, and Labor Relations Files". In a companion release the Commission is publishing a Privacy Act system of records notice to make technical amendments to this system of records to incorporate minor corrective and administrative modifications that have occurred since the notice was last published and will update the system name to more accurately reflect the records contained in the system. The Commission is amending its inventory of exempted systems of records reflect the new title of this system of records.

Finally, the Commission is making a technical amendment to its inventory of exempted systems of records by removing a reference to the system of records titled: "Personnel Security Files". On August 8, 2000 (65 FR 49037), the Commission published notice to delete this system of records as the records were duplicative of records in: "Personnel Investigations Records (OPM/Central-9)", published by the United States Office of Personnel Management.

**General Request for Comment**

The Commission requests comment on the proposed amendments in this release.

**Paperwork Reduction Act**

The proposed amendments do not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995."[2] Accordingly, the Paperwork Reduction Act is not applicable.

**Cost-Benefit Analysis**

The Commission is sensitive to the costs and benefits that result from its rules. This proposal would exempt portions of three new systems of records from provisions of the Privacy Act in so far as the records contain investigatory materials compiled for law enforcement purposes. As more fully described above, the TCR Records system of records, the SEC Security in the Workplace Incident Reports system of records and the IRIS system of records may include investigatory materials compiled in connection with the Commission's enforcement of the federal securities laws, in connection with potential or actual incidents of workplace violence, or in connection with public complaints/inquiries/request. Access to or disclosure of the investigatory materials in these systems of records could seriously undermine the effective enforcement of the federal securities laws, and the safety and security of Commission employees

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[2] 44 U.S.C. 3501 *et seq.*

in the workplace. We recognize that our proposed amendments may impose costs on individuals who may wish to obtain access to records that contain investigatory materials in these systems of records. Congress seems to have contemplated these costs in promulgating the exemption in 5 U.S.C. 552a(k)(2).

**Regulatory Flexibility Act Certification**

Section 3(a) of the Regulatory Flexibility Act of 1980[3] ("RFA") requires the Commission to undertake an initial regulatory flexibility analysis of the proposed rule amendments on small entities unless the Commission certifies that the proposal, if adopted, would not have a significant economic impact on a substantial number of small entities.[4] Pursuant to 5 U.S.C. 605(b), the Commission hereby certifies that the proposed amendments to 17 CFR 200.312 would not, if adopted, have a significant economic impact on a substantial number of small entities. The proposed amendments would exempt portions of three new systems of records from provisions of the Privacy Act in so far as the records contain investigatory materials compiled for law enforcement purposes. Because the proposed amendments would apply solely to private individuals, the proposed amendments would not, if adopted, have a significant economic impact on a substantial number of "small entities," as defined by the RFA.[5] We encourage written comments regarding this certification.

**Statutory Authority**

The Commission is proposing amendments to 17 CFR 200.312 under the authority in 5 U.S.C. 552a(k)(2) and 5 U.S.C. 552a(k)(5).

**List of Subjects in 17 CFR Part 200**

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3 5 U.S.C. 603(a).

4 5 U.S.C. 605(b).

5 *See* 5 U.S.C. 601(6).

Administrative practice and procedure; Privacy.

**Text of Proposed Amendments**

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

**PART 200- ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS**

**Subpart H—Regulations Pertaining to the Privacy of Individuals and Systems of Records Maintained by the Commission**

1. The authority citation for Part 200 is revised by adding authority for §200.312 in numerical order to read as follows:

   Authority: 15 U.S.C. 77o, 77s, 77sss, 78d, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 80a-37, 80b-11, and 7202, unless otherwise noted.

* * * * *

Section 312 is also issued under 5 U.S.C. 552a(k).

2. Remove the authority citation at the end of §200.312.
3. Amend §200.312 by:

   a. removing "and" at the end of paragraph (a)(5);

   b. adding paragraphs (a)(7), (a)(8) and (a)(9); and

   c. revising paragraph (b).

The revisions read as follows.

**§ 200.312 Specific exemptions.**

* * * * *

(a) * * *

(7) Tips, Complaints, and Referrals (TCR) Records;

(8) SEC Security in the Workplace Incident Records; and

(9) Investor Response Information System (IRIS).

(b) Pursuant to 5 U.S.C. 552a(k)(5), the system of records containing the Commission's Disciplinary and Adverse Actions, Employee Conduct, and Labor Relations Files shall be exempt from sections (c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) of the Privacy Act, 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (e)(4)(H), and (e)(4)(I), and (f), and 17 CFR 200.303, 200.304, and 200.306 insofar as they contain investigatory material compiled to determine an individual's suitability, eligibility, and qualifications for federal civilian employment or access to classified information, but only to the extent that the disclosure of such material would reveal the identity of a source who furnished information to the Government under an express promise that the identity of the source would be held in confidence, or, prior to September 27, 1975, under an implied promise that the identity of the source would be held in confidence.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: May 18, 2011

**SECURITIES AND EXCHANGE COMMISSION**

[Release No. PA-46; File No. S7-20-11]

**Privacy Act of 1974:** Systems of Records.

**AGENCY**: Securities and Exchange Commission.

**ACTION**: Notice to establish three new systems of records and revise two existing systems of records.

**SUMMARY:** In accordance with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a, the Securities and Exchange Commission ("Commission" or "SEC") proposes to establish three new systems of records and revise two existing systems of records. The three new systems of records are "Tips, Complaints, and Referrals (TCR) Records (SEC-63)", "SEC Security in the Workplace Incident Records (SEC-64), and "Investor Response Information System (IRIS) (SEC-65)." In a companion release published elsewhere in this issue of the Federal Register the Commission is issuing a Proposed Rule concurrent with this notice. Additionally, two existing systems of records are being revised: "Personnel Management Code of Conduct and Employee Performance Files (SEC-38)", last published in the Federal Register Volume 62, Number 176 on Thursday, September 11, 1997; and "Enforcement Files (SEC-42)", last published in the Federal Register Volume 67, Number 142 on Wednesday, July 24, 2002.

**DATES**: The proposed systems will become effective [insert date that is 40 days after publication in the Federal Register] unless further notice is given. The Commission will publish a new notice if the effective date is delayed to review comments or if changes are made based on comments received. To be assured of consideration, comments should be received on or before [insert date that is 30 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-20-11 on the subject line.

Paper Comments:

Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number S7-20-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/other.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 available publicly.

**FOR FURTHER INFORMATION CONTACT:** Cristal Perpignan, Acting Chief Privacy Officer, Office of Information Technology, 202-551-7716.

**SUPPLEMENTARY INFORMATION:** The Commission proposes to establish three new systems of records, "Tips, Complaints, and Referrals (TCR) Records (SEC-63)", "SEC Security in the Workplace Incident Records (SEC-64)", and "Investor Response Information System (IRIS) (SEC-65)." The TCR Records (SEC-63) system of records contains records related to tips, complaints, referrals of misconduct, or related information about actual or potential violations of the federal securities laws; investor harm; conduct of public companies; securities professionals; regulated entities; and associated persons. The SEC Security in the Workplace Incident Records (SEC-64) system of records contains records related to reports involving incidents of assault, harassment, intimidation, bullying, weapons possession or threats at the SEC workplace. The IRIS (SEC-65) system of records contains records related to complaints/inquiries/requests from members of the public and others. In a companion release published elsewhere in this issue of the Federal Register the Commission is issuing a Notice of Proposed Rulemaking concurrent with this notice to exempt these systems from certain provisions of the Privacy Act to the extent that they contain investigatory materials for law enforcement purposes.

Additionally, the Commission proposes to revise two existing systems of records, "Personnel Management Code of Conduct and Employee Performance Files (SEC-38)", and "Enforcement Files (SEC-42)". As described in the last published notice, the Personnel Management Code of Conduct and Employee Performance Files (SEC-38) system is used to verify employee and agency compliance with law, regulation, case decisions, agency policies, and the Collective Bargaining Agreement. Minor administrative changes to SEC-38 have been incorporated to reflect the Commission's current address in the following sections: System Location; and Notification, Access and Contesting Records Procedures. Substantive changes to the notice have been made to the following sections: (1) System Name, reflecting the new title: "Disciplinary and Adverse Actions, Employee Conduct, and Labor Relations Files"; (2) Categories of Records, deleting records no longer maintained in this system; and (3) Routine Uses, adding certain standard routine uses as applicable to this system of records (those numbered 1, 2, 4, 5, 6, 7, 8, and 9). On September 8, 2009 (74 FR 46254), the Commission published notice that records related to the Ethics Conduct Rules applicable to Commission

Members and employees, including reports on securities transactions, holdings, and accounts required by applicable Federal securities laws and regulations, which were previously contained in SEC-38, would be maintained in a new systems of records titled: Ethics Conduct Rules Files (SEC-60). The Categories of Records Section of SEC-38 has been revised to reflect the removal of these records.

As described in the last published notice, the Enforcement Files (SEC-42) system will be used for purposes of the Commission's investigations and actions to enforce the federal securities laws. Additionally, the information in the system is used in conjunction with the collection of amounts ordered to be paid in enforcement actions. Minor administrative changes to SEC-42 have been incorporated to reflect the Commission's current address in the following sections: System Location; and Notification, Access and Contesting Records Procedures. A substantive change to the notice has been made to the Routine Uses section to allow disclosure of records in the event of a breach of records.

The Commission has submitted a report of the new systems of records and the amended existing systems of records to the appropriate Congressional committees and to the Director of the Office of Management and Budget ("OMB") as required by 5 U.S.C. 552a(r) (Privacy Act of 1974) and guidelines issued by OMB on December 12, 2000 (65 FR 77677).

Accordingly, the Commission is proposing three new systems of records and amendment of two existing systems of records to read as follows:

**SEC-63**

**SYSTEM NAME:**

Tips, Complaints, and Referrals (TCR) Records.

**SYSTEM LOCATION:**

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Files may also be maintained in the Commission's Regional Offices that conducted an investigation or litigation.

**CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:**

(1) Individuals that submit tips, complaints, or related information about actual or potential violations of the federal securities laws; investor harm; conduct of public companies, securities professionals, regulated entities, and associated persons; and internal and external referrals of misconduct; (2) Individuals that are the subjects of a tip or complaint related to an actual or potential securities law violation; (3) Attorneys or other related individuals; and (4) SEC personnel or contractors assigned to handle such tips, complaints, and referrals.

**CATEGORIES OF RECORDS IN THE SYSTEM:**

Records may include individual names; dates of birth; social security numbers; addresses; telephone numbers; tip, complaint, and referral information including allegation descriptions, dates, and supporting details; supporting documentation; web forms; e-mails; criminal history; working papers of the staff; and other documents and records relating to the matter.

**AUTHORITY FOR MAINTENANCE OF THE SYSTEM:**

15 U.S.C. 77a et seq., 78a et seq., 80a-1 et seq., 80b-1 et seq., and 5 U.S.C. 302.

**PURPOSE(S):**

For use by authorized SEC personnel in receiving, recording, assigning, tracking, and taking action on tips, complaints, and referrals received from individuals and entities related to actual or potential violations of the federal securities laws; investor harm; or conduct of public companies, securities professionals, regulated entities and associated persons.

**ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:**

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.
2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation;

state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.

4. By SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities laws.
5. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
6. In connection with proceedings by the Commission pursuant to Rule 102(e) of its Rules of Practice, 17 CFR 201.102(e).
7. To a bar association, state accountancy board, or other federal, state, local, or foreign licensing or oversight authority; or professional association or self-regulatory authority to the extent that it performs similar functions (including the Public Company Accounting Oversight Board) for investigations or possible disciplinary action.
8. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee; the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.
9. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
10. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and

maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.

11. To any trustee, receiver, master, special counsel, or other individual or entity that is appointed by a court of competent jurisdiction, or as a result of an agreement between the parties in connection with litigation or administrative proceedings involving allegations of violations 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)) or pursuant to the Commission's Rules of Practice, 17 CFR 201.100 – 900 or the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106, or otherwise, where such trustee, receiver, master, special counsel, or other individual or entity is specifically designated to perform particular functions with respect to, or as a result of, the pending action or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice or the Rules of Fair Fund and Disgorgement Plans.

12. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.

13. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data

analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.

14. In reports published by the Commission pursuant to authority granted in the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), which authority shall include, but not be limited to, section 21(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(a)).
15. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.
16. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.
17. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
18. To members of Congress, the press, and the public in response to inquiries relating to particular Registrants and their activities, and other matters under the Commission's jurisdiction.

19. To prepare and publish information relating to violations of the federal securities laws as provided in 15 U.S.C. 78c(a)(47)), as amended.
20. To respond to subpoenas in any litigation or other proceeding.
21. To a trustee in bankruptcy.
22. To members of Congress, the General Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

**STORAGE:**

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

**RETRIEVABILITY:**

Records may be retrieved by an individual's or entity's name, receipt date, subject matter, keywords that may include personal information, and/or other personal identifier. The system will also enable authorized SEC personnel to search for and retrieve records using conventional methods including but not limited to the use of unique record identifiers, keyword searches, geographic data (e.g. zip code), date and time searches, and sorts and filters.

**SAFEGUARDS:**

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Access is limited to those personnel whose official duties require access. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission are contractually obligated to maintain equivalent safeguards.

**RETENTION AND DISPOSAL:**

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

**SYSTEM MANAGER(S) AND ADDRESS:**

Deputy Director, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549

**NOTIFICATION PROCEDURE:**

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**RECORD ACCESS PROCEDURES:**

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**CONTESTING RECORD PROCEDURES:**

See Record Access Procedures above.

**RECORD SOURCE CATEGORIES:**

Information in these records may be supplied by investors and the general public, Commission-regulated entities including broker-dealers, investment advisers, self-regulatory organizations, other government agencies, and foreign regulators.

**EXEMPTIONS CLAIMED FOR THE SYSTEM:**

Under 5 U.S.C. 552a(k)(2), this system of records is exempted from the following provisions of the Privacy Act, 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) and 17 CFR 200.303, 200.304, and 200.306, insofar as it contains investigatory materials compiled for law enforcement purposes. This exemption is contained in 17 CFR 200.312(a)(1).

**SEC- 64**

**SYSTEM NAME:**

SEC Security in the Workplace Incident Records.

**SYSTEM LOCATION:**

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

**CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:**

Past and present employees, interns, and volunteers of the Securities and Exchange Commission (employees), contractors, visitors, and others who have access to SEC facilities who report potential or actual workplace violence; persons accused of threatening to commit, or committing workplace violence, and persons interviewed or investigated in connection with reports or allegations of potential or actual workplace violence.

**CATEGORIES OF RECORDS IN THE SYSTEM:**

These records include, but are not limited to: Case number, victim's name, office telephone number, room number, office/division, duty station, position, supervisor, supervisor's telephone number, location of incident, activity at time of incident, circumstances surrounding the incident, perpetrator, name(s) and telephone number(s) of witness(es), injured party(s), medical treatment(s), medical report, property damages, report(s) to police, and related information needed to investigate violence, threats, harassment, intimidation, or other inappropriate behavior causing SEC employees, contractors, or other individuals to fear for their personal safety in the SEC workplace.

**AUTHORITY FOR MAINTENANCE OF THE SYSTEM:**

5 U.S.C. 7902(d) and (e).

**PURPOSE(S):**

The records are used by SEC personnel to take action on, or to respond to a complaint about a threat, harassment, intimidation, violence, or other inappropriate behavior involving one or more SEC employees, contractors, interns, or other individuals against an SEC employee; and to make assessments of violent or potentially violent situations and then make recommendations regarding interventions for those persons involved with the situations.

**ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:**

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure

made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

2. When a person or property is harmed, or when threats of harm to a person or property are reported, disclosure will be made, as appropriate, to law enforcement authorities, medical treatment authorities, and those persons being threatened or harmed.
3. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign securities authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
4. To a bar association, a state accountancy board, the Public Company Accounting Oversight Board, or any similar federal, state, or local licensing authority for possible disciplinary action.
5. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee; the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.
6. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
7. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and

maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.

8. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.

9. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.

10. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.

11. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in

connection with the Commission's enforcement or regulatory functions under the federal securities laws.

12. To a Congressional office in response to an inquiry from that Congressional office made at the request of the individual to whom the record pertains.
13. To respond to subpoenas in any litigation or other proceeding.
14. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

**STORAGE:**

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc in accordance with all appropriate laws. Paper records are stored in locked file rooms and/or file cabinets.

**RETRIEVABILITY:**

Records are retrieved by name or case designation (those who reported a violent or potentially violent event and those who were reported), event date, and event location.

**SAFEGUARDS:**

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. Access is limited to those personnel whose official duties require access. Paper records are maintained in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Computerized records are safeguarded through use of access codes and information technology security.

**RETENTION AND DISPOSAL:**

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

**SYSTEM MANAGER(S) AND ADDRESS:**

Chief, SEC Security Branch, 100 F Street, NE, Washington, DC 20549-5100

**NOTIFICATION PROCEDURE:**

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**RECORD ACCESS PROCEDURE:**

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/Privacy Act Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**CONTESTING RECORD PROCEDURES:**

See Record Access Procedures above.

**RECORD SOURCE CATEGORIES:**

Records source is from individuals who report potential or actual workplace security incidents, and reports made on individuals interviewed or investigated in connection with allegations of potential or actual workplace security incidents.

**EXEMPTIONS CLAIMED FOR THE SYSTEM:**

Under 5 U.S.C. 552a(k)(2), this system of records is exempted from the following provisions of the Privacy Act, 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) and 17 CFR

200.303, 200.304, and 200.306, insofar as it contains investigatory materials compiled for law enforcement purposes. This exemption is contained in 17 CFR 200.312(a)(1).

**SEC-65**

**SYSTEM NAME:**

Investor Response Information System (IRIS).

**SYSTEM LOCATION:**

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Also, records covered by Subsystem A are received by and maintained in the Commission's Regional Offices, whose addresses are listed below under System Manager(s) and Address.

**CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:**

**Subsystem A:**

Records are maintained on members of the public and others who submit inquiries or make complaints to the Commission, generally, or to Divisions and Offices of the Commission or who contact the Office of Investor Education and Advocacy (OIEA) or the Commission's Regional Offices.

**Subsystem B:**

Records are maintained on members of the public, members of Congress or their staff, and others who address their inquiries or complaints to the Commission's Chairman or the Office of Legislative and Intergovernmental Affairs.

**Subsystem C:**

Records are maintained on members of the public who submit requests for copies of, or review of records accessible through the Commission's Public Reference Room.

**Subsystem D:**

Computerized records are comprised of data collected in all of the above subsystems.

**CATEGORIES OF RECORDS IN THE SYSTEM:**

Both electronic and paper records in this system/subsystems may contain the name of the complainant/inquirer/requester or their representative, the name of the entity and/or subject of the complaint/inquiry/request, the date relating to the receipt and disposition of the complaint/inquiry/request and, where applicable, the type of complaint/inquiry/request and other information derived from or relating to the complaint/inquiry/request. Paper records may include, but are not limited to, letters of complaint/inquiry/request, responses, and related documentation.

**AUTHORITY FOR MAINTENANCE OF THE SYSTEM:**

15 U.S.C. 77s, 77sss, 78d, 78d-1, 78d-2, 78w, 78ll(d), 79t, 80a-37, and 80b-11.

**PURPOSE(S):**

The records will be used by the staff to track and process complaints/inquiries/requests from members of the public and others.

**ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:**

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security

or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.
4. By SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities laws.
5. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
6. In connection with proceedings by the Commission pursuant to Rule 102(e) of its Rules of Practice, 17 CFR 201.102(e).
7. To a bar association, state accountancy board, or other federal, state, local, or foreign licensing or oversight authority; or professional association or self-regulatory authority to the

extent that it performs similar functions (including the Public Company Accounting Oversight Board) for investigations or possible disciplinary action.

8. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee; the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.
9. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
10. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
11. To any trustee, receiver, master, special counsel, or other individual or entity that is appointed by a court of competent jurisdiction, or as a result of an agreement between the parties in connection with litigation or administrative proceedings involving allegations of violations 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)) or pursuant to the Commission's Rules of Practice, 17 CFR 201.100 – 900 or the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106, or otherwise, where such trustee, receiver, master, special

counsel, or other individual or entity is specifically designated to perform particular functions with respect to, or as a result of, the pending action or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice or the Rules of Fair Fund and Disgorgement Plans.

12. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.
13. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
14. In reports published by the Commission pursuant to authority granted in the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), which authority shall include, but not be limited to, section 21(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(a)).
15. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.

16. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.
17. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
18. To members of Congress, the press, and the public in response to inquiries relating to particular Registrants and their activities, and other matters under the Commission's jurisdiction.
19. To prepare and publish information relating to violations of the federal securities laws as provided in 15 U.S.C. 78c(a)(47)), as amended.
20. To respond to subpoenas in any litigation or other proceeding.
21. To a trustee in bankruptcy.
22. To members of Congress, the General Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
23. To respond to inquiries from individuals who have submitted complaints/inquiries/request, or from their representatives.
24. To entities against which complaints/inquiries/requests are directed when Commission staff requests them to research the issues raised and report back to the staff.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

**STORAGE:**

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in file rooms and/or file cabinets, as well as off-site locations including the Federal Records Center, pursuant to applicable record retention guidelines.

**RETRIEVABILITY:**

By use of the computerized records in Subsystem D, the files (both paper and electronic) in Subsystems A, B, and C are retrievable by the name, receipt date, name of the registered representative or associated person named in the complaint/inquiry/request, or the name of the entity/issuer that is the subject of the complaint/inquiry/request.

**SAFEGUARDS:**

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in file cabinets and/or offices or file rooms at all other times. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission are contractually obligated to maintain equivalent safeguards.

**RETENTION AND DISPOSAL:**

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

**SYSTEM MANAGER(S) AND ADDRESS:**

**Subsystem A**: Chief Counsel, Office of Investor Education and Advocacy, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549; New York Regional Office, Regional Director, 3 World Financial Center, Suite 400, New York, NY 10281-1022; Boston Regional Office, Regional Director, 33 Arch Street, 23rd Floor, Boston, MA 02110-1424; Philadelphia Regional Office, Regional Director, The Mellon Independence Center, 701 Market Street, Suite 2000, Philadelphia, PA 19106-1532; Miami Regional Office, Regional Director, 801 Brickell Avenue, Suite 1800, Miami, FL 33131-4901, Atlanta Regional Office, Regional Director, 3475 Lenox Road, NE, Suite 1000, Atlanta, GA 30326-1232; Chicago Regional Office, Regional Director, 175 West Jackson Boulevard, Suite 900, Chicago, IL 60604-2908; Denver Regional Office, Regional Director, 1801 California Street, Suite 1500, Denver, CO 80202-2656; Fort Worth Regional Office, Regional Director, Burnett Plaza, Suite 1900, 801 Cherry Street, Unit #18, Fort Worth, TX 76102-6882; Salt Lake Regional Office, Regional Director, 15 West South Temple Street, Suite 1800, Salt Lake City, UT 84101-1573; Los Angeles Regional Office, Regional Director, 5670 Wilshire Boulevard, 11th Floor, Los Angeles, CA 90036-3648; San Francisco Regional Office, Regional Director, 44 Montgomery Street, Suite 2600, San Francisco, CA 94104-4716. **Subsystem B**: Office of the Chairman, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. **Subsystem C:** Records Officer, Office of Records Management Services, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549, **Subsystem D**: Chief Information Officer, Office of Information Technology, Securities and Exchange Commission, Operations Center, Mail Stop 0-4, 6432 General Green Way, Alexandria, VA 22312.

**NOTIFICATION PROCEDURE:**

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**RECORD ACCESS PROCEDURES:**

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**CONTESTING RECORD PROCEDURES:**

See Record access procedures above.

**RECORD SOURCE CATEGORIES:**

Information collected in all subsystems is received from individuals primarily through letters, telephone calls, or personal visits to the Commission's offices.

**EXEMPTIONS CLAIMED FOR THE SYSTEM:**

Under 5 U.S.C. 552a(k)(2), this system of records is exempted from the following provisions of the Privacy Act, 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) and 17 CFR 200.303, 200.304, and 200.306, insofar as it contains investigatory materials compiled for law enforcement purposes. This exemption is contained in 17 CFR 200.312(a)(1).

**SEC-38**

**SYSTEM NAME:**

Disciplinary and Adverse Actions, Employee Conduct, and Labor Relations Files.

**SYSTEM LOCATION:**

Securities and Exchange Commission, Office of Human Resources100 F Street NE, Washington, DC 20549-3990.

**CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:**

Present and former SEC employees.

**CATEGORIES OF RECORDS IN THE SYSTEM:**

The system of records includes information in the following categories of records: (a) Disciplinary and adverse action cases, regulatory appeal files, grievances and complaints relating to an employee, union issues (including collective bargaining documents and dues withholding forms), leave bank/transfer date, and third party complaints; (b) Investigatory materials gathered in connection with the individual's initial appointment to the agency as well as materials gathered in connection with investigations into allegations of employee misconduct.

**AUTHORITY FOR MAINTENANCE OF THE SYSTEM:**

5 U.S.C. §1302 & §2951 and 17 C.F.R. § 200.735-13

**PURPOSE(S):**

Assigned staff uses records to verify employee and agency compliance with law, regulation, case decisions, agency policies, and the Collective Bargaining Agreement.

**ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:**

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security

or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. In any proceeding where the human resources law or regulations are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
4. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee; the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.
5. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
6. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters

related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.

7. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
8. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
9. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
10. To a commercial contractor in connection with benefit programs administered by the contractor on the Commission's behalf, including, but not limited to, supplemental health, dental, disability, life and other benefit programs.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

**STORAGE:**

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

**RETRIEVABILITY:**

Records are indexed and retrieved by employee name or assigned ID.

**SAFEGUARDS:**

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Access is limited to those personnel whose official duties require access. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission are contractually obligated to maintain equivalent safeguards.

**RETENTION AND DISPOSAL:**

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

**SYSTEM MANAGER(S) AND ADDRESS:**

Associate Executive Director, Office of Human Resources, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-3990.

**NOTIFICATION PROCEDURE:**

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**RECORD ACCESS PROCEDURES:**

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**CONTESTING RECORD PROCEDURES:**

See Record access procedures above.

**RECORD SOURCE CATEGORIES:**

Employees, managers, union officials.

**EXEMPTIONS CLAIMED FOR THE SYSTEM:**

Under 5 U.S.C. 552a(k)(2), this system of records is exempted from the following provisions of the Privacy Act, 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) and 17 CFR 200.303, 200.304, and 200.306, insofar as it contains investigatory materials compiled to determine an individual's suitability, eligibility, and qualifications for Federal civilian employment or access to classified information, but only to the extent that the disclosure of such material would reveal the identity of a source who furnished information to the Government under an express promise that the identity of the source would be held in confidence, or, prior to September 27, 1975, under an implied promise that the identity of the source would be held in confidence. This exemption is contained in 17 CFR 200.312(b)(1).

**SEC-42**

**SYSTEM NAME:**

Enforcement Files.

**SYSTEM LOCATION:**

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Files may also be maintained in the Commission's Regional Offices that conducted an investigation or litigation, or at a records management company under contract with the Commission. Closed investigatory files are stored at a federal records center.

**CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:**

Records are maintained on persons who have been involved in Commission investigations or litigation, or in activities which violated or may have violated federal, state or foreign laws relating to transactions in securities, the conduct of securities business or investment advisory activities, and banking or other financial activities.

**CATEGORIES OF RECORDS IN THE SYSTEM:**

Records contain names and addresses of persons involved in Commission investigations or litigation. Also, correspondence relevant to the matter, internal staff memoranda, Commission Minutes and Commission Orders, copies of subpoenas issued in the course of the matter, affidavits, transcripts of testimony and exhibits thereto, copies of pleadings and exhibits in related private or governmental actions, documents and other evidence obtained in the course of the matter, computerized records, working papers of the staff and other documents and records relating to the matter, opening reports, progress reports and closing reports, and miscellaneous records relating to investigations or litigation.

**AUTHORITY FOR MAINTENANCE OF THE SYSTEM:**

15 U.S.C. 77s, 77t, 78u, 77uuu, 80a-41, and 80b-9. 17 CFR 202.5.

**PURPOSE(S):**

The records are maintained for purposes of the Commission's investigations and actions to enforce the federal securities laws. Additionally, the information in the system is used in conjunction with the collection of amounts ordered to be paid in enforcement actions, a function that is a necessary component of litigation.

**ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:**

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.
2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.

3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.
4. By SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities laws.
5. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
6. In connection with proceedings by the Commission pursuant to Rule 102(e) of its Rules of Practice, 17 CFR 201.102(e).
7. To a bar association, state accountancy board, or other federal, state, local, or foreign licensing or oversight authority; or professional association or self-regulatory authority to the extent that it performs similar functions (including the Public Company Accounting Oversight Board) for investigations or possible disciplinary action.
8. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee; the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.
9. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security

clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.

10. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
11. To any trustee, receiver, master, special counsel, or other individual or entity that is appointed by a court of competent jurisdiction, or as a result of an agreement between the parties in connection with litigation or administrative proceedings involving allegations of violations 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)) or pursuant to the Commission's Rules of Practice, 17 CFR 201.100 – 900 or the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106, or otherwise, where such trustee, receiver, master, special counsel, or other individual or entity is specifically designated to perform particular functions with respect to, or as a result of, the pending action or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice or the Rules of Fair Fund and Disgorgement Plans.
12. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters

related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.

13. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
14. In reports published by the Commission pursuant to authority granted in the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), which authority shall include, but not be limited to, section 21(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(a)).
15. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.
16. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.

17. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
18. To members of Congress, the press, and the public in response to inquiries relating to particular Registrants and their activities, and other matters under the Commission's jurisdiction.
19. To prepare and publish information relating to violations of the federal securities laws as provided in 15 U.S.C. 78c(a)(47)), as amended.
20. To respond to subpoenas in any litigation or other proceeding.
21. To a trustee in bankruptcy.
22. To any governmental agency, governmental or private collection agent, consumer reporting agency or commercial reporting agency, governmental or private employer of a debtor, or any other person, for collection, including collection by administrative offset, federal salary offset, tax refund offset, or administrative wage garnishment, of amounts owed as a result of Commission civil or administrative proceedings.

**DISCLOSURE TO CONSUMER REPORTING AGENCIES:**

When the Commission seeks to collect a debt arising from a civil action or administrative proceeding, it may disclose the following information to a consumer reporting agency: (i) information necessary to establish the identity of the debtor, including name, address and taxpayer identification number or social security number; (ii) the amount, status, and history of the debt; and (iii) the fact that the debt arose from a Commission action or proceeding to enforce the federal securities laws.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

**STORAGE:**

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

**RETRIEVABILITY:**

The records are retrieved by the name under which the investigation is conducted or administrative or judicial litigation is filed. Access to information about an individual may be obtained through the Commission's Name-Relationship Search Index system by the name of the individual. Information concerning an individual may also be obtained by reference to computer-based indices maintained by the Division of Enforcement.

**SAFEGUARDS:**

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Access is limited to those personnel whose official duties require access. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission are contractually obligated to maintain equivalent safeguards.

**RETENTION AND DISPOSAL:**

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

**SYSTEM MANAGER(S) AND ADDRESS:**

Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-0801; Records Officer, Office of Records Management Services, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549; New York Regional Office, Regional Director, 3 World Financial Center, Suite 400, New York, NY 10281-1022; Boston Regional Office, Regional Director, 33 Arch Street, 23rd Floor, Boston, MA 02110-1424; Philadelphia Regional Office, Regional Director, The Mellon Independence Center, 701 Market Street, Philadelphia, PA 19106-1532; Miami Regional Office, Regional Director, 801 Brickell Ave., Suite 1800, Miami, FL 33131, Atlanta Regional Office, Regional Director, 3475 Lenox Road, N.E., Suite 1000, Atlanta, GA 30326-1232; Chicago Regional Office, Regional Director, 175 W. Jackson Boulevard, Suite 900, Chicago, IL 60604; Denver Regional Office, Regional Director, 1801 California Street, Suite 1500, Denver, CO 80202-2656; Fort Worth Regional Office, Regional Director, Burnett Plaza, Suite 1900, 801 Cherry Street, Unit 18, Fort Worth, TX 76102; Salt Lake Regional Office, Regional Director, 15 W. South Temple Street, Suite 1800, Salt Lake City, UT 84101; Los Angeles Regional Office, Regional Director, 5670 Wilshire Boulevard, 11th Floor, Los Angeles, CA 90036-3648; San Francisco Regional Office, Regional Director, 44 Montgomery Street, Suite 2600, San Francisco, CA 94104.

**NOTIFICATION PROCEDURE:**

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**RECORD ACCESS PROCEDURES:**

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5100.

**CONTESTING RECORD PROCEDURES:**

See Record Access Procedures above.

**RECORD SOURCE CATEGORIES:**

Information in these records is supplied by: Individuals including, where practicable, those to whom the information relates; witnesses, banks, corporations, or other entities; self-regulatory organizations; the Postal Inspection Service, the Department of Justice, state securities commissions, other Federal, state, or local bodies and law enforcement agencies or foreign governmental authorities; public sources, i.e., libraries, newspapers, television, radio, court records, filings with Federal, state, and local bodies; filings made with the SEC pursuant to law; electronic information sources; other offices within the Commission; documents, litigation, transcripts of testimony, evidence introduced into court, orders entered by a court and correspondence relating to litigation; pleadings in administrative proceedings, transcripts of testimony, documents, including evidence entered in such proceedings, and miscellaneous other sources.

**EXEMPTIONS CLAIMED FOR THE SYSTEM:**

Under 5 U.S.C. 552a(k)(2), this system of records is exempted from the following provisions of the Privacy Act, 5 U.S.C. 552a(c)(3), (d), (e)(1), (e)(4)(G), (H), and (I), and (f) and 17 CFR 200.303, 200.304, and 200.306, insofar as it contains investigatory materials compiled for law enforcement purposes. This exemption is contained in 17 CFR 200.312(a)(1).

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: May 18, 2011

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 232, 240, and 249, and 249b

Release No. 34-64514; File No. S7-18-11

RIN 3235-AL15

**Proposed Rules for Nationally Recognized Statistical Rating Organizations**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rules.

**SUMMARY:** In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and to enhance oversight, the Securities and Exchange Commission ("Commission") is proposing amendments to existing rules and new rules that would apply to credit rating agencies registered with the Commission as nationally recognized statistical rating organizations ("NRSROs"). In addition, in accordance with the Dodd-Frank Act, the Commission is proposing a new rule and form that would apply to providers of third-party due diligence services for asset-backed securities. Finally, the Commission is proposing amendments to existing rules and a new rule that would implement a requirement added by the Dodd-Frank Act that issuers and underwriters of asset-backed securities make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. The Commission is requesting comment on the proposed rule amendments and new rules.

**DATES:** Comments should be received on or before [*insert date that is 60 days after date of publication in the Federal Register*].

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number [____] 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 [____]. 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.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549. All comments received will be posted without change; the Commission does 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; Raymond A. Lombardo, Branch Chief, at (202) 551-5755; Rose Russo Wells, Senior Counsel, at (202) 551-5527; Joseph I. Levinson, Special Counsel, at (202) 551-5598; or Timothy C. Fox, Special Counsel, at (202) 551-5687; Division of Trading and Markets; or, with respect to the proposals for issuers and underwriters of asset-backed securities, Eduardo A. Aleman, Special Counsel, Division of Corporation Finance at (202) 551-3430; Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-7010.

**SUPPLEMENTARY INFORMATION:** The Commission, with respect to NRSROs, is proposing amendments to rules 17 CFR 232.101 ("Rule 101 of Regulation S-T"), 17 CFR 232.201 ("Rule 201 of Regulation S-T"), 17 CFR 240.17g-1 ("Rule 17g-1"), 17 CFR 240.17g-2 ("Rule 17g-2"), 17 CFR 240.17g-3 ("Rule 17g-3"), 17 CFR 240.17g-5 ("Rule 17g-5"), 17 CFR 240.17g-6 ("Rule 17g-6"), 17 CFR 240.17g-7 ("Rule 17g-7"), 17 CFR 249b.300 ("Form NRSRO"), and proposing new rules 17 CFR 240.17g-8 ("Rule 17g-8") and 17 CFR 240.17g-9 ("Rule 17g-9").

In addition, the Commission, with respect to providers of third-party due diligence services for asset-backed securities, is proposing new rules 17 CFR 240.17g-10 ("Rule 17g-10") and 17 CFR 249b.400 ("Form ABS Due Diligence-15E").

Finally, the Commission, with respect to issuers and underwriters of asset-backed securities, is proposing amendments to 17 CFR 232.314 ("Rule 314 of Regulation S-T") and 17 CFR 249.1400 ("Form ABS 15G"), and proposing new rule 17 CFR 240.15Ga-2 ("Rule 15Ga-2").

## I. BACKGROUND

Title IX, Subtitle C of the Dodd-Frank Act,[1] "Improvements to the Regulation of Credit Rating Agencies," among other things, establishes new self-executing requirements applicable to NRSROs, requires certain studies,[2] and requires that the Commission adopt rules applicable to

1 Pub. L. No. 111-203, 124 Stat. 1376, H.R. 4173 (July 21, 2010).

2 See Pub. L. No. 111-203 §§ 939, 939D - 939F. On December 17, 2010, the Commission issued a request for comments to inform a required study on standardizing credit ratings terminology. See Credit Rating Standardization Study, Securities Exchange Act of 1934 ("Exchange Act") Release No. 34-63573 (December 17, 2010). On May 10, 2011, the

NRSROs in a number of areas.[3] The NRSRO provisions in the Dodd-Frank Act augment the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act of 2006"), which established a registration and oversight program for NRSROs through self-executing provisions added to the Exchange Act and implementing rules adopted by the Commission under the

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Commission issued a request for comments to assist it in carrying out a required study on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products. See Solicitation of Comment to Assist in Study on Assigned Credit Ratings, Exchange Act Release No. 64456 (May 10, 2011). The Commission also is required to conduct a study of the independence of NRSROs and how that independence affects the ratings issued by NRSROs. The Comptroller General of the United States is required to conduct a study on alternative means for compensating NRSROs in order to create incentives to provide more accurate credit ratings as well as a study on the feasibility and merits of creating an independent professional organization for rating analysts employed by NRSROs.

3 See Pub. L. No. 111-203 §§ 931-939H. In addition, Title IX, Subtitle D, "Improvements to the Asset-Backed Securitization Process," contains Section 943, which provides that the Commission shall adopt rules, within 180 days, requiring an NRSRO to include in any report accompanying a credit rating of an asset-backed security a description of the representations, warranties, and enforcement mechanisms available to investors and how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities. See Pub. L. No. 111-203 § 943. On January 20, 2011, the Commission adopted Rule 17g-7 to implement Section 943. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act of 1933 ("Securities Act") Release No. 9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011) and 17 CFR 240.17g-7. Prior to enactment of the Dodd-Frank Act and the adoption of Rule 17g-7, the Commission proposed a different rule to be codified at 17 CFR 240.17g-7. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008). This proposed rule would have required an NRSRO to publish a report containing certain information with the publication of a credit rating for a structured finance product or, as an alternative, use ratings symbols for structured finance products that differentiate them from the credit ratings for other types of debt securities. Id. In November 2009, the Commission announced it was deferring consideration of action on the proposal and separately proposed a different rule to be codified at 17 CFR 240.17g-7 that would have required an NRSRO to annually disclose certain information. See Proposed Rules for Nationally Recognized Statistical Rating Organizations Exchange Act Release No. 61051 (Nov. 23, 2009), 74 FR 63866 (Dec. 4, 2009). Although the Commission adopted Rule 17g-7 on January 20, 2011 to implement Section 943 of the Dodd-Frank Act, the November 23, 2009 proposal remains outstanding.

Exchange Act as amended by the Rating Agency Act of 2006.[4] Title IX, Subtitle C of the Dodd-Frank Act also provides that the Commission shall prescribe the format of a certification that providers of third-party due diligence services would need to provide to each NRSRO producing a credit rating for an asset-backed security to which the due diligence services relate.[5] Finally, Title IX, Subtitle C of the Dodd-Frank Act establishes a new requirement for issuers and underwriters of asset-backed securities to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.[6]

## II. THE PROPOSED NEW RULES AND RULE AMENDMENTS

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4 See Pub. L. No. 109-291 (2006). The Rating Agency Act of 2006, among other things, amended Section 3 of the Exchange Act to add definitions, added Section 15E to the Exchange Act to establish self-executing requirements on NRSROs and provide the Commission with the authority to implement a registration and oversight program for NRSROs, amended Section 17 of the Exchange Act to provide the Commission with recordkeeping, reporting, and examination authority over NRSROs, and amended Section 21B(a) of the Exchange Act to provide the Commission with the authority to assess penalties in administrative proceedings instituted under Section 15E of the Exchange Act. See Pub. L. No. 109-291 §§ 3 and 4 and 15 U.S.C. 78c, 78o-7, 78q, and 78u-2. The Commission adopted rules to implement a registration and oversight program for NRSROs in June 2007. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 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 has proposed further amendments to these rules, which remain pending. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63866 (Dec. 4, 2009). In addition, as noted above, the Commission adopted Rule 17g-7 on January 20, 2011.

5 See Pub. L. No. 111-203 § 932(a)(8) adding new paragraph (s)(4)(C) to Section 15E of the Exchange Act. 15 U.S.C. 78o-7(s)(4)(C).

6 See Pub. L. No. 111-203 § 932(a)(8) adding new paragraph (s)(4)(A) to Section 15E of the Exchange Act. 15 U.S.C. 78o-7(s)(4)(A).

The Commission's proposed rule amendments and proposed new rules to implement Title IX, Subtitle C of the Dodd-Frank Act are described below.[7]

## A. INTERNAL CONTROL STRUCTURE

### 1. Self-Executing Requirement

Section 932(a)(2)(B) of the Dodd-Frank Act added paragraph (3) to Section 15E(c) of the Exchange Act.[8] Section 15E(c)(3)(A) requires an NRSRO to "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into

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[7] As used throughout this release, the term "category" of credit rating refers to a distinct level in a rating scale represented by a unique symbol, number, or score. For example, if a rating scale consists of symbols (e.g., AAA, AA, A, BBB, BB, B, CCC, CC, and C), each unique symbol would represent a category in the rating scale. Similarly, if a rating scale consists of numbers (e.g., 1, 2, 3, 4, 5, 6, 7, 8, and 9), each number would represent a category in the rating scale. Each category also represents a "notch" in the rating scale. In addition, some NRSRO rating scales attach additional symbols or numbers to the symbols representing categories in order to denote gradations within a category. For example, a rating scale may indicate gradations within a category by attaching a plus or a minus or a number to a rating symbol. For example, AA+, AA, and AA- or AA1, AA2, and AA3 would be three gradations within the AA category. If a rating scale has gradations within a category, each category and gradation within a category would constitute a "notch" in the rating scale. For example, the following symbols would each represent a notch in the rating scale in descending order: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, CCC+, CCC, CCC-, CC, C and D. Furthermore, for the purposes of this release, changing a credit rating (e.g., upgrading or downgrading the credit rating) means assigning a credit rating at a different notch in the rating scale (e.g., downgrading an obligor assigned an AA rating to an AA- rating or an A+ rating). A "rating action" for the purposes of this release does not necessarily mean changing a credit rating. A rating action is taken when an NRSRO issues an expected or preliminary credit rating before it issues an initial credit rating, issues an initial credit rating, upgrades an existing credit rating, downgrades an existing credit rating (including to a default category), places an existing credit rating on credit watch or review (meaning the NRSRO is actively evaluating whether to change the credit rating), affirms (or confirms) an existing credit rating (meaning the NRSRO announces that it will not change the credit rating), or withdraws a credit rating.

[8] See Pub. L. No. 111-203 § 932(a)(2)(B) and 15 U.S.C. 78o-7(c)(3)(A).

consideration such factors as the Commission may prescribe, by rule."[9] While Section 15E(c)(3)(A) provides that the Commission "may" prescribe factors an NRSRO would need to take into consideration with respect to an internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings (an "internal control structure"), the requirement that an NRSRO "establish, maintain, enforce, and document an effective internal control structure" is self-executing.[10] Consequently, an NRSRO must adhere to this self-executing provision irrespective of whether the Commission prescribes factors the NRSRO must take into consideration.[11]

The Commission preliminarily believes it would be appropriate at this time to defer prescribing factors an NRSRO must take into consideration with respect to its internal control structure. Deferring rulemaking would provide the Commission with the opportunity, through the NRSRO examination process and, as discussed below, the submission of annual reports by the NRSROs, to review how the NRSROs have complied with this self-executing requirement.[12] This review could inform any future rulemaking the Commission may initiate. Nonetheless, the Commission is requesting extensive comment below on whether it would be appropriate as part of this rulemaking to prescribe factors. Based on the comments received, the Commission may

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9 Id.

10 Id.

11 Id.

12 Section 923(a)(8) of the Dodd-Frank Act struck existing Section 15E(p) of the Exchange Act, which related to the date of applicability of the Rating Agency Act of 2006 and added new Section 15E(p). See Pub. L. No. 111-203 § 932(a)(8). New Section 15E(p)(3) of the Exchange Act requires, among other things, the Commission staff to conduct an examination of each NRSRO at least annually. See 15 U.S.C. 78o-7(p)(3). The Commission staff intends to conduct such annual statutory examinations on a cycle based on the Commission's fiscal year. The staff intends to conduct the first annual statutory examination of a newly registered NRSRO in the annual cycle following its registration.

decide to prescribe by rule or identify through guidance the factors an NRSRO would need to consider with respect to its internal control structure.

Request for Comment

The Commission generally requests comment on all aspects of Section 15E(c)(3)(A) of the Exchange Act. The Commission also seeks comment on the following:

1. Should the Commission, as part of this rulemaking initiative, prescribe factors that an NRSRO would need to take into consideration when establishing, maintaining, enforcing, and documenting an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings? For example, can the objectives of the self-executing requirement in Section 15E(c)(3)(A) of the Exchange Act be adequately achieved by NRSROs if the Commission does not prescribe factors?
2. Alternatively, should the Commission defer rulemaking in order to review through examination and monitoring the effectiveness of the internal control structures each NRSRO establishes, maintains, enforces, and documents pursuant to Section 15E(c)(3)(A) of the Exchange Act? For example, would it be more appropriate for the Commission to evaluate through examination and the annual reports discussed below in Section II.A.3 of this release whether there is a need to prescribe factors and, if such a need is identified, incorporate in rulemaking or guidance best practices identified through examination and NRSRO reporting?
3. If appropriate to prescribe factors now, should the factors address all elements of the self-executing requirement in Section 15E(c)(3)(A) of the Exchange Act (i.e., the establishment, maintenance, enforcement, and documentation of the internal control

structure) or should the factors focus on the design (i.e., establishment) of the internal control structure or one of the other elements or a combination of some of the elements?

4. If appropriate to prescribe factors now for the establishment of an internal control structure, what should those factors be? For example, should the Commission prescribe any of the factors identified in the sub-paragraphs below? In analyzing these potential factors, commenters should address the potential advantages, disadvantages, benefits, and costs that could result if the Commission prescribed any of the factors, as well as the potential effectiveness of the controls and any practical issues related to implementing them.

   a. Controls reasonably designed to ensure that a newly developed methodology or proposed update to an in-use methodology for determining credit ratings is subject to an appropriate review process (e.g., by persons who are independent from the persons that developed the methodology or methodology update) and to management approval prior to the new or updated methodology being employed by the NRSRO to determine credit ratings;[13]

   b. Controls reasonably designed to ensure that a newly developed methodology or update to an in-use methodology for determining credit ratings is disclosed to the public for consultation prior to the new or updated methodology being employed by the NRSRO to determine credit ratings, that the NRSRO makes comments

[13] Section 15E(t)(3)(A) of the Exchange Act contains a self-executing provision requiring that the board of directors of the NRSRO shall "oversee" the "establishment, maintenance, and enforcement of policies and procedures for determining credit ratings." See 15 U.S.C. 78o-7(t)(3)(A). At the same time, Section 15E(r) of the Exchange Act requires the Commission to adopt rules "to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models" that are approved by the board of the NRSRO. See 15 U.S.C. 78o-7(r)(1)(A).

received as part of the consultation publicly available, and that the NRSRO considers the comments before implementing the methodology;

c. Controls reasonably designed to ensure that in-use methodologies for determining credit ratings are periodically reviewed (e.g., by persons who are independent from the persons who developed and/or use the methodology) in order to analyze whether the methodology should be updated;

d. Controls reasonably designed to ensure that market participants have an opportunity to provide comment on whether in-use methodologies for determining credit ratings should be updated, that the NRSRO makes any such comments received publicly available, and that the NRSRO considers the comments;

e. Controls reasonably designed to ensure that newly developed or updated quantitative models proposed to be incorporated into a credit rating methodology are evaluated and validated prior to being put into use;

f. Controls reasonably designed to ensure that quantitative models incorporated into in-use credit rating methodologies are periodically reviewed and back-tested;

g. Controls reasonably designed to ensure that an NRSRO engages in analysis before commencing the rating of a class of obligors, securities, or money market instruments the NRSRO has not previously rated to determine whether the NRSRO has sufficient competency, access to necessary information, and resources to rate the type of obligor, security, or money market instrument;

h. Controls reasonably designed to ensure that an NRSRO engages in analysis before commencing the rating of an "exotic" or "bespoke" type of obligor, security, or money market instrument to review the feasibility of determining a credit rating;

i. Controls reasonably designed to ensure that measures (e.g., statistics) are used to evaluate the performance of credit ratings as part of the review of in-use methodologies for determining credit ratings to analyze whether the methodologies should be updated or the work of the analysts employing the methodologies should be reviewed;

j. Controls reasonably designed to ensure that, with respect to determining credit ratings, the work and conclusions of the lead credit analyst developing an initial credit rating or conducting surveillance on an existing credit rating is reviewed by other analysts, supervisors, or senior managers before a rating action is formally taken (e.g., having the work reviewed through a rating committee process);

k. Controls reasonably designed to ensure that a credit analyst documents the steps taken in developing an initial credit rating or conducting surveillance on an existing credit rating with sufficient detail to permit an after-the-fact review or internal audit of the rating file to analyze whether the analyst adhered to the NRSRO's procedures and methodologies for determining credit ratings;

l. Controls reasonably designed to ensure that the NRSRO conducts periodic reviews or internal audits of rating files to analyze whether analysts adhere to the NRSRO's procedures and methodologies for determining credit ratings; or

m. Any other factors that commenters identify and explain.

5. If appropriate to prescribe factors now for the maintenance of an internal control structure, what should those factors be? For example, should the Commission prescribe

any of the factors identified in the sub-paragraphs below? In analyzing these potential factors, commenters should address the potential advantages, disadvantages, benefits, and costs that could result if the Commission prescribed any of the factors, as well as the potential effectiveness of the controls and any practical issues related to implementing them.

a. Controls reasonably designed to ensure that the NRSRO conducts periodic reviews of whether it has devoted sufficient resources to implement and operate the documented internal control structure as designed;

b. Controls reasonably designed to ensure that the NRSRO conducts periodic reviews or ongoing monitoring to evaluate the effectiveness of the internal control structure and whether it should be updated;

c. Controls designed to ensure that any identified deficiencies in the internal control structure are assessed and addressed on a timely basis;

d. Any other factors that commenters identify and explain.

6. If appropriate to prescribe factors now for the <u>enforcement</u> of an internal control structure, what should those factors be? For example, should the Commission prescribe any of the factors identified in the sub-paragraphs below? In analyzing these potential factors, commenters should address the potential advantages, disadvantages, benefits, and costs that could result if the Commission prescribed any of the factors, as well as the potential effectiveness of the controls and any practical issues related to implementing them.

a. Controls designed to ensure that additional training is provided or discipline taken with respect to employees who fail to adhere to requirements imposed by the internal control structure;

b. Controls designed to ensure that a process is in place for employees to report failures to adhere to the internal control structure; or

c. Any other factors that commenters identify and explain?

7. If appropriate to prescribe factors now for the documentation of an internal control structure, what should those factors be? For example, should there be a factor relating to the level of written detail about the internal control structure that should be documented? Are there other factors that should be considered? What potential advantages, disadvantages, benefits, and costs would result if the Commission prescribed any such factors?

8. Identify any other factors that an NRSRO should consider when establishing, maintaining, enforcing, and documenting an internal control structure. Explain the utility of any factors identified as well as the potential advantages, disadvantages, benefits, and costs that could result if the Commission prescribed any such factors.

### 2. Proposed Amendment to Rule 17g-2

As noted above, Section 15E(c)(3)(A) of the Exchange Act requires an NRSRO, among other things, to document its internal control structure.[14] Thus, the statute itself requires the NRSRO to make this record.[15] However, the statute does not prescribe how an NRSRO would need to maintain this record.[16] The Commission preliminarily believes this record should be

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14 See 15 U.S.C. 78o-7(c)(3)(A).

15 Id.

16 Id. For example, it does not prescribe how long the document must be retained.

subject to the same recordkeeping requirements applicable to other records an NRSRO is required to retain pursuant to the NRSRO recordkeeping rule – Rule 17g-2.[17] Consequently, the Commission proposes adding new paragraph (b)(12) to Rule 17g-2 to identify the internal control structure an NRSRO, among other things, must document pursuant to Section 15E(c)(3)(A) of the Exchange Act as a record that must be retained.[18] As a result, the various retention and production requirements of paragraphs (c), (d), (e), and (f) of Rule 17g-2 would apply to the documented internal control structure.[19]

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[17] 17 CFR 240.17g-2(c), (d), (e), and (f). Section 17(a)(1) of the Exchange Act requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. 15 U.S.C. 78q(a)(1). The Commission preliminarily believes it would be necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act to apply the record retention requirements of Rule 17g-2 to the internal control structure required pursuant to Section 15E(c)(3)(A) of the Exchange Act (15 U.S.C. 78o-7(c)(3)(A)). See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33582 (June 18, 2007) ("The Commission designed [Rule 17g-2] based on its experience with recordkeeping rules for other regulated entities. These other books and records rules have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws. Rule 17g–2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is complying with the provisions of Section 15E of the Exchange Act and the rules thereunder.") (footnotes omitted).

[18] See proposed new paragraph (b)(12) of Rule 17g-2.

[19] See 17 CFR 240.17g-2(c), (d), (e) and (f). Paragraph (c) of Rule 17g-2 requires an NRSRO to retain the records identified in paragraphs (a) and (b) for three years after the date the record is made or received. 17 CFR 240.17g-2(c). Paragraph (d) requires, among other things, that an NRSRO maintain each record identified in paragraphs (a) and (b) in a manner that makes the original record or copy easily accessible to the principal office of the NRSRO. 17 CFR 240.17g-2(d). Paragraph (e) sets forth the requirements that apply when an NRSRO uses a third-party custodian to maintain its records. 17 CFR 240.17g-2(e). Paragraph (f) requires an NRSRO to promptly furnish the Commission with legible, complete, and current copies, and, if specifically requested, English translations, of the records identified in paragraphs (a) and (b), or any other records of the NRSRO subject to examination under Section 17(b) of the Exchange Act. See 17 CFR 240.17g-2(f); see also 15 U.S.C. 78q(b).

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (b)(12) of Rule 17g-2.

### 3. Proposed Amendments to Rule 17g-3

Section 15E(c)(3)(B) of the Exchange Act provides that the Commission shall prescribe rules requiring an NRSRO to "submit" an annual internal controls report to the Commission, which shall contain: (1) a description of the responsibility of management in establishing and maintaining an effective internal control structure; (2) an assessment of the effectiveness of the internal control structure; and (3) the attestation of the chief executive officer ("CEO") or equivalent individual.[20] Rule 17g-3 requires an NRSRO to furnish annual reports to the Commission.[21] In particular, paragraph (a) of Rule 17g-3 requires an NRSRO to furnish five or, in some cases, six separate reports within 90 days after the end of the NRSRO's fiscal year and identifies the reports that must be furnished.[22] The first report – the NRSRO's financial statements – must be audited; the remaining reports may be unaudited.[23] Paragraph (b) of Rule 17g-3 provides that the NRSRO must attach to the reports a signed statement by a duly authorized person that the person has responsibility for the reports and, to the best knowledge of the person, the reports fairly present, in all material respects, the information contained in the reports.[24]

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20 See 15 U.S.C. 78o-7(c)(3)(B)(i)-(iii).

21 See 17 CFR 240.17g-3.

22 See 17 CFR 240.17g-3(a)(1)-(6).

23 Id.

24 See 17 CFR 240.17g-3(b).

The Commission proposes amending paragraphs (a) and (b) of Rule 17g-3 to implement the rulemaking mandated by Section 15E(c)(3)(B) of the Exchange Act.[25] The proposed amendment would add a new paragraph (a)(7) to require an NRSRO to file an additional report – the report on the NRSRO's internal control structure – with its annual submission of reports pursuant to Rule 17g-3.[26] As discussed above in Section II.A.1 of this release, the Commission preliminarily believes it would be appropriate at this time to defer prescribing factors an NRSRO must take into consideration with respect to its internal control structure. For similar reasons, the Commission preliminarily believes it would be appropriate at this time to implement Sections 15E(c)(3)(B)(i) and (ii) of the Exchange Act through rule text that closely mirrors the statute.[27] Consequently, proposed new paragraph (a)(7) would require that the internal control report contain: (1) a description of the responsibility of management in establishing and maintaining an effective internal control structure; and (2) an assessment by management of the effectiveness of the internal control structure.[28] As is the case with the reports currently identified in paragraphs (a)(2) through (a)(6) of Rule 17g-3, the report identified in new paragraph (a)(7) would be

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25 See 15 U.S.C. 78o-7(c)(3)(B)(i)-(iii). In addition, as a technical amendment, the Commission proposes to amend the title of Rule 17g-3 to replace the words "financial reports" with the words "financial and other reports." The Commission notes that the report identified in paragraph (a)(6) of Rule 17g-3, the proposed internal control report, and the compliance report discussed below in Section II.K of this release are not financial in nature. The Commission also proposes to add the word "filed" in the title of Rule 17g-3. As discussed below in Section II.M.1 of this release, the Commission is proposing amendments to Rules 17g-1 and 17g-3 to treat certain submissions of Form NRSRO and the Rule 17g-3 annual reports as being "filed" as opposed to being "furnished" to conform to amendments the Dodd-Frank Act made to Section 15E of the Exchange Act. See Pub. L. No. 111-203 § 932(a). Specifically, the reports identified in paragraphs (a)(1), (2), (3), (4), (5), (7) and (8) of Rule 17g-3 would be "filed" and the report identified in paragraph (a)(6) would be "furnished."

26 See proposed new paragraph (a)(7) of Rule 17g-3.

27 See 15 U.S.C. 78o-7(c)(3)(B)(i) and (ii).

28 Compare 15 U.S.C. 78o-7(c)(3)(B)(i) and (ii) with proposed new paragraphs (a)(7)(i) and (ii) of Rule 17g-3.

unaudited.[29] While the proposed rule text closely mirrors the statutory text, the Commission is requesting extensive comment below on whether it would be appropriate as part of this rulemaking to provide more explanation in terms of the standards to use in preparing the internal controls report and providing information in the report. Based on the comments received, the Commission may decide to prescribe by rule or identify through guidance such standards.

Section 15E(c)(3)(B)(iii) of the Exchange Act provides that the annual internal controls report must contain an attestation of the NRSRO's CEO, or equivalent individual.[30] Accordingly, the Commission proposes amending paragraph (b) of Rule 17g-3 to require that the NRSRO's chief executive officer, or, if the firm does not have a CEO, an individual performing similar functions, provide a signed statement that would need to be attached to the report.[31]

Request for Comment

The Commission generally requests comment on all aspects of these proposed amendments to paragraphs (a) and (b) of Rule 17g-3. The Commission also seeks comment on the following:

1. Is the requirement to provide a description of the responsibility of management in establishing and maintaining an effective internal control structure sufficiently explicit?

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29 See proposed new paragraph (a)(7) of Rule 17g-3.

30 15 U.S.C. 78o-7(c)(3)(B)(iii).

31 See proposed amendments to paragraph (b) of Rule 17g-3. In particular, the Commission proposes re-organizing existing paragraph (b) of Rule 17g-3 into paragraphs (b)(1) and (b)(2). Paragraph (b)(1) would contain the current requirement that the NRSRO must attach to each of the annual reports required pursuant to paragraphs (a)(1)-(6) a signed statement by a duly authorized person associated with the NRSRO stating that the person has responsibility for the financial reports and, to the best knowledge of the person, the reports fairly present, in all material respects, the information required to be contained in the report. Paragraph (b)(2) of Rule 17g-3 would require that the report on the NRSRO's internal control structure be attested to by the NRSRO's CEO or an individual performing similar functions. See proposed paragraph (b)(2) of Rule 17g-3.

If not, how should the Commission modify proposed paragraph (a)(7) of Rule 17g-3 to make the requirement more understandable? For example, should the Commission provide guidance on how an NRSRO must describe the responsibility of management in establishing and maintaining an effective internal control structure? If so, what should that guidance be? For example, are there existing frameworks that such guidance could be modeled on?

2. In terms of establishing an effective internal control structure, what level of NRSRO management should have primary responsibility for the design of the internal control structure and what level of management should supervise the design of the internal control structure? For example, should managers with direct responsibility for supervising the personnel who use the policies, procedures, and methodologies for determining credit ratings and the personnel who conduct compliance reviews for adherence to those policies, procedures, and methodologies design the internal control structure and a committee of the NRSRO's most senior managers supervise the design of the internal control structure? Should other management or non-management levels of the NRSRO have responsibility for either of these functions? In addition, Section 15E(t)(3)(C) of the Exchange Act provides that the board of directors of the NRSRO shall "oversee" the "effectiveness of the internal control system with respect to the policies and procedures for determining credit ratings."[32] How should this statutorily mandated board responsibility be integrated with the responsibility of the NRSRO's management to establish an effective internal control structure?

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[32] See 15 U.S.C. 78o-7(t)(3)(A).

3. In terms of establishing an effective internal control structure, should the Commission define the term "internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings"? In terms of establishing an effective internal control structure, should the Commission further define the term "internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings"? If so, how should that term be further defined?[33] Provide suggested rule text and supporting analysis.
4. In terms of establishing an effective internal control structure, should the Commission prescribe a standard in terms of the design? If so, what standard would be appropriate? For example, should the internal control structure be "reasonably designed" to achieve its objectives (a standard required by Sections 15E(g) and (h) of the Exchange Act with respect to policies and procedures of an NRSRO to address, respectively, the misuse of material nonpublic information and conflicts of interest)?[34] Conversely, is the proposed requirement that the internal control structure be "effective" a sufficient standard?
5. In terms of maintaining an effective internal control structure, what level of NRSRO management should have primary responsibility for monitoring the operation of the internal control structure and the NRSRO's adherence to the internal control structure? For example, should managers with direct responsibility for supervising the personnel who use the policies, procedures, and methodologies for determining credit ratings and the personnel who conduct compliance reviews for adherence to those policies,

33 The term "internal control" has been defined in other contexts. For example, the Commission has defined internal control over financial reporting. See 17 CFR 240.13a-15(f).

34 See 15 U.S.C. 78o-7(g) and (h).

procedures, and methodologies have day-to-day responsibility for monitoring the operation of the internal control structure and the NRSRO's adherence to the internal control structure? Should other management or non-management levels of the NRSRO have responsibility for either of these functions? For example, should the personnel responsible for monitoring the operation of the internal control structure and the NRSRO's adherence to the internal control structure generate periodic (weekly, monthly, quarterly, and/or annual) reports that are provided to the NRSRO's most senior managers and the board about the internal control structure? If so, what information should be contained in those reports? In addition, Section 15E(t)(3)(C) of the Exchange Act provides that the board of directors of the NRSRO shall "oversee" the "effectiveness of the internal control system with respect to the policies and procedures for determining credit ratings."[35] How should this statutorily mandated board responsibility be integrated with the responsibility of the NRSRO's management to maintain an effective internal control structure?

6. Is the requirement to provide an assessment by management of the effectiveness of the internal control structure sufficiently explicit? If not, how should the Commission modify proposed paragraph (a)(7) of Rule 17g-3 to make the requirement more understandable? For example, given that the NRSRO needs to maintain the internal control structure (i.e., keep it in operation), should the Commission clarify that the assessment should address the effectiveness of the internal control structure during the entire fiscal year covered by the report?

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35 See 15 U.S.C. 78o-7(t)(3)(A).

7. In terms of reporting management's assessment of the effectiveness of the internal control structure, should the Commission provide guidance on how an NRSRO must assess the effectiveness of the internal control structure, such as evaluative criteria or standards? If so, what should those criteria or standards be? For example, should the Commission require that management's assessment of the effectiveness of the internal control structure be based on procedures sufficient to evaluate the design of the internal control structure and test its operating effectiveness?

8. In terms of management's assessment of the effectiveness of the internal control structure, should the Commission define the conditions that preclude management from concluding that the internal control structure is effective? If so, how should an ineffective internal control structure be defined? For example, should management be precluded from concluding that the internal control structure is effective if there are one or more instances of "material weaknesses" in the internal control structure? If one or more instances of "material weaknesses" should preclude management from concluding that its internal control structure is effective, then should the Commission define "material weakness"? If so, how should the term "material weakness" be defined? If management cannot conclude that the internal control structure is effective, what corrective action or sanctions should be imposed on the NRSRO?

9. In terms of reporting management's assessment of the effectiveness of the internal control structure, should the Commission provide guidance regarding the topics to be addressed in the report? If so, what should that guidance be? For example, if the Commission prescribes factors that an NRSRO should take into consideration in establishing, maintaining, enforcing, and documenting its internal control structure,

should the report specifically reference those factors? In addition, should the report identify or describe the framework management used to conduct the evaluation of the effectiveness of the internal control structure? Moreover, should the report identify deficiencies found during the assessment process? If so, should all deficiencies be identified or only those which preclude management from concluded that the internal control structure is effective? Furthermore, should the Commission require that the report disclose whether there were any significant changes in the internal control structure or other factors that could significantly affect the internal control structure subsequent to the date of the evaluation, including any corrective actions in response to any material weaknesses found during the evaluation?

10. In terms of reporting management's assessment of the effectiveness of the internal control structure, should the report identify any fraud, significant errors, or previously undisclosed conflicts of interest identified during the assessment of the effectiveness of the internal control structure that could have a material effect on the integrity of the NRSRO's procedures and methodologies for determining credit ratings? What other disclosures should the report contain?

11. Should an NRSRO be required to maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the internal control structure that could be used by Commission examination staff to review the adequacy of the assessment? In this regard, should the Commission identify specific objectives of an internal control structure that the evidential matter would need to support? For example, should the evidential matter provide reasonable support for an assessment that the internal control structure is designed to effectively prevent or detect

failures of the NRSRO to adhere to its policies, procedures, and methodologies for determining credit ratings? If such specific objectives should be identified, describe them and identify the evidential matter that could be retained to allow the Commission examination staff to review the adequacy of the NRSRO's assessment of the effectiveness of the internal control structure in achieving the objective.

12. With respect to proposed paragraph (b)(2) of Rule 17g-3, should the Commission provide more guidance on the type of management responsibilities that would qualify an individual as one who performs functions similar to a CEO? If so, what are those types of responsibilities?
13. Should the Commission require the internal control report to be filed separately from the Rule 17g-3 annual reports (which are kept confidential to the extent permitted by law) and, instead, require the internal control report to be disclosed to the public on, for example, the Commission's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system? What would be the benefits and costs of requiring the public disclosure of the report?
14. If it would be appropriate to make the report public, should the Commission prescribe a form for the report? If so, what information should the form require the NRSRO to provide in the disclosure? What would the form look like? Could any of the Commission's current forms serve as a model? If so, identify the forms and explain how they could be tailored to require an NRSRO to provide information about its internal control structure.

## B. CONFLICTS OF INTEREST RELATING TO SALES AND MARKETING

Section 932(a)(4) of the Dodd-Frank Act added new paragraph (3) to Section 15E(h) of the Exchange Act.[36] Section 15E(h)(3)(A) of the Exchange Act provides that the Commission shall issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO.[37] Section 15E(h)(3)(B) of the Exchange Act provides that the Commission's rules must contain two additional provisions.[38] First, Section 15E(h)(3)(B)(i) requires that the Commission's rules shall provide for exceptions for small NRSROs with respect to which the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate.[39] Second, Section 15E(h)(3)(B)(ii) requires that the Commission's rules shall provide for the suspension or revocation of the registration of an NRSRO if the Commission finds, on the record, after notice and opportunity for a hearing, that: (1) the NRSRO has committed a violation of a rule issued under Section 15E(h) of the Exchange Act; and (2) the violation affected a rating.[40]

The Commission proposes to implement Sections 15E(h)(3)(A), (B)(i), and (B)(ii) of the Exchange Act by amending the NRSRO conflict of interest rule – Rule 17g-5.[41] The proposals would amend the rule by: (1) identifying a new prohibited conflict in paragraph (c) of the rule; (2) adding a new paragraph (f) setting forth the finding the Commission would need to make in

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36 Pub. L. No. 111-203 § 932(a)(4) and 15 U.S.C. 78o-7(h)(3).

37 15 U.S.C. 78o-7(h)(3)(A).

38 15 U.S.C. 78o-7(h)(3)(B)(i) and (ii).

39 15 U.S.C. 78o-7(h)(3)(B)(i).

40 15 U.S.C. 78o-7(h)(3)(B)(ii).

41 17 CFR 240.17g-5. The Commission adopted and subsequently amended Rule 17g-5 pursuant, in part, to authority in Section 15E(h)(2) of the Exchange Act (15 U.S.C. 78o-7(h)(2)). See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33595-33599 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6465-6469 (Feb. 9, 2009); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63842-63850 (Dec. 4, 2009).

order to grant a small NRSRO an exemption from the prohibition; and (3) adding a new paragraph (g) setting forth the standard for suspending or revoking an NRSRO's registration for violating a rule adopted under Section 15E(h) of the Exchange Act.

### 1. Proposed New Prohibited Conflict

As noted above, Section 15E(h)(3)(A) of the Exchange Act provides that the Commission shall issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of ratings by the NRSRO.[42] The Commission is proposing to implement this provision by identifying a new conflict of interest in paragraph (c) of Rule 17g-5.[43] Paragraph (c) prohibits a person within an NRSRO (as well as the NRSRO itself)[44] from having any of the conflicts of interest relating to the issuance or maintenance of a credit rating or credit rating agency identified in the paragraph under all circumstances (hereinafter the "absolute prohibitions").[45] Proposed new paragraph (c)(8) of Rule 17g-5 would identify a new absolute prohibition; namely, one in which the NRSRO issues or maintains a credit rating where a person within the NRSRO who participates in the sales or marketing of a product or service of the NRSRO or a product or service of a person associated with the NRSRO also participates in determining or monitoring the credit rating, or developing or approving procedures or

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42 15 U.S.C. 78o-7(h)(3)(A).

43 See proposed new paragraph (c)(8) of Rule 17g-5.

44 See paragraph (d) of Rule 17g-5 defining "person within an NRSRO" for purposes of the rule. 17 CFR 240.17g-5(d).

45 See 17 CFR 240.17g-5(c)(1)-(7). These absolute prohibitions are distinguished from the types of conflicts identified in paragraph (b) of Rule 17g-5, which are prohibited unless the NRSRO has taken the steps to address them set forth in paragraph (a) of Rule 17g-5. See 17 CFR 240.17g-5(a) and (b).

methodologies used for determining the credit rating, including qualitative or quantitative models.[46]

The proposed new absolute prohibition would be designed to address situations in which, for example, individuals within the NRSRO responsible for selling its products and services could seek to influence a specific credit rating to favor an existing or prospective client or the development of a credit rating methodology to favor a class of existing or prospective clients. With regard to methodologies, the Commission notes that its staff found as part of the examination of the activities of the three largest NRSROs in rating residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime mortgages that it appeared "employees responsible for obtaining ratings business would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria."[47] The absolute prohibition in proposed paragraph (c)(8) of Rule 17g-5 would be designed to insulate individuals within the NRSRO responsible for the analytic function from such sales and marketing concerns and pressures.

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (c)(8) of Rule 17g-5. The Commission also seeks comment on the following:

1. Would the proposed amendment impact existing governance structures, reporting lines and internal organizations of NRSROs, particularly smaller NRSROs? If so, provide specific information about the nature and consequences of such impacts.

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46 See proposed new paragraph (c)(8) of Rule 17g-5.

47 See Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies, Commission (July 2008), pp. 25-26.

2. Are there sales and marketing activities persons that participate in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings, including qualitative or quantitative models, could participate in without undermining the goal of proposed paragraph (a)(8) of Rule 17g-5? If so, what types of activities? How could proposed new paragraph (a)(8) of Rule 17g-5 be modified to retain an absolute prohibition and at the same time not prohibit persons who participate in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings, including qualitative or quantitative models, to participate in sales and marketing activities that do not expose them to business concerns that could compromise their analytical integrity?
3. Should the Commission provide guidance on what constitutes a sales and marketing activity? If so, how should the Commission define "sales and marketing activities"? In addition, should the Commission define what it means to "participate in sales and marketing activities"? Similarly, should the Commission define what it means to "participate in developing or approving procedures and methodologies used for determining credit ratings"? If so, how should the Commission define these terms?
4. Identify other requirements applicable to NRSROs that are designed to address this conflict of interest.

### 2. Proposed Exemption for "Small" NRSROs

Section 15E(h)(3)(B)(i) of the Exchange Act requires that the Commission's rules under Section 15E(h)(3)(A) shall provide for exceptions for small NRSROs with respect to which the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate.[48] To implement this provision, the Commission is proposing to amend Rule 17g-5 by adding a new paragraph (f).[49] Proposed paragraph (f) would provide a mechanism for a small NRSRO to apply in writing for an exemption from the absolute prohibition proposed in new paragraph (c)(8).[50] In particular, proposed new paragraph (f) of Rule 17g-5 would provide that upon written application by an NRSRO, the Commission may exempt, either conditionally or unconditionally or on specified terms and conditions, such NRSRO from the provisions of paragraph (c)(8) of Rule 17g-5 if the Commission finds that due to the small size of the NRSRO it is not appropriate to require the separation within the NRSRO of the production of credit ratings from sales and marketing activities and such exemption is in the public interest.[51]

The Commission preliminarily believes that the absolute prohibition should apply to all NRSROs. However, the Commission notes that in some cases the small size of an NRSRO could make a complete separation of the sales and marketing function from the credit rating analytical function inappropriate. For example, the NRSRO may not have enough staff (or the resources to hire additional staff) to establish separate functions. In such a case, the Commission

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48 See 15 U.S.C. 78o-7(h)(3)(B)(i).

49 See proposed new paragraph (f) of Rule 17g-5.

50 Section 36 of the Exchange Act provides that the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions from any provision or provisions of the Exchange Act or any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. 17 U.S.C. 78mm. Consequently, an NRSRO could request to be exempt from the proposed sales and marketing prohibition pursuant to this more general authority in Section 36. See id. Nonetheless, the Commission has adopted rules providing mechanisms for registrants – such as broker-dealers – to request an exemption from specific rule requirements. See, e.g., 17 CFR 240.15c3-1(b)(3); 17 CFR 240.15c3-3(k)(3); and 17 CFR 240.17a-5(m)(3). The Commission preliminarily believes proposed paragraph (f) of Rule 17g-5 should parallel such provisions.

51 See proposed new paragraph (f) of Rule 17g-5.

would entertain requests for relief. In granting such relief, the Commission may impose conditions designed to preserve as much of the separation between these two functions as possible.

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (f) of Rule 17g-5. The Commission also seeks comment on the following:

1. The Commission notes that Section 15E(h)(3)(A) of the Exchange Act provides that the Commission shall issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO. Section 15E(h)(3)(B)(i) requires that the Commission's rules shall provide for exceptions for small NRSROs with respect to which the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate (emphasis added). Why would the separation of the production of ratings from sales and marketing activities be appropriate for NRSROs that are not small but might not be appropriate for NRSROs that are small? For example, does the small size of an NRSRO make the conflict less likely to influence ratings? If so, why? Alternatively, could the small size of an NRSRO make the application of the absolute prohibition impractical, thus preventing a small credit rating agency from seeking registration or a small NRSRO from maintaining its registration? If so, would the adverse impact on competition outweigh the benefit of applying the absolute prohibition to a small NRSRO? If so, explain how.
2. Would the case-by-case approach proposed by the Commission appropriately implement Section 15E(h)(3)(B)(i) of the Exchange Act? If not, how should the proposal be modified? For example, should the Commission prescribe an objective self-executing

exemption from the absolute prohibition in proposed paragraph (c)(8) of Rule 17g-5? For example, should the exemption be automatic for "small" NRSROs? If so, how should the Commission define a small NRSRO? For example, should the definition be based on the total assets of the NRSRO? In this regard, should the Commission adopt a rule that exempts any NRSRO that has total assets of $5 million or less from the absolute prohibition given that is how the Commission currently defines a small NRSRO for purposes of the Regulatory Flexibility Act?[52] How would such an exemption work in practice? For example, would such a rule need to provide for a transition period for an NRSRO that crosses the total asset threshold to provide time to establish the separate sales and marketing function? How long should such a transition period be? For example, should it be 90, 120, 180 or some other number of days after the required filing date of the NRSRO's audited financial statements indicating the threshold was crossed are required to be filed with the Commission?

3. What other factors should the Commission consider in analyzing whether the small size of an NRSRO makes it not appropriate to require the separation of the production of credit ratings from sales and marketing activities? Should the Commission consider the annual revenues of the NRSRO? Should the Commission consider the number of employees of the NRSRO? Would consideration of the number of employees create a disincentive to devote resources to adequately staff the NRSRO? Are there factors in

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52 See Section VII.C of this release; see also 5 U.S.C. 603(a), Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR 33618 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6481 (Feb. 9, 2009); and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63863 (Dec. 4, 2009).

addition to an NRSRO's size the Commission should consider in analyzing whether to grant an exemption under this proposal? If so, please describe any such factors.

4. If the Commission granted relief to an NRSRO, should the Commission specify conditions for obtaining the relief? If so, what should those conditions be? For example, should the conditions limit the number of credit analysts that can participate in sales and marketing activities, limit the manner in which they can participate in such activities, require additional procedures to address the conflict, and require additional procedures to document how credit analysts participate in sales and marketing activities? If any of these conditions would be appropriate, describe how they could be implemented in practice.

### 3. Suspending or Revoking a Registration

Section 15E(h)(3)(B)(ii) of the Exchange Act specifies that the Commission's rules under Section 15E(h) of the Exchange Act shall provide for suspension or revocation of the registration of an NRSRO if the Commission finds, on the record, after notice and opportunity for a hearing, that the NRSRO has committed a violation of "a rule issued under this subsection" and the violation of the rule affected a credit rating.[53] While Section 15E(h)(3)(A) relates only to the conflict arising from sales and marketing activities, Section 15E(h)(3)(B)(ii) – by using the term "subsection" – has a broader scope in that it refers to all rules issued under Section 15E(h) of the Exchange Act.[54] Consequently, the rule implementing Section 15E(h)(3)(B)(ii) must provide for the suspension or revocation of an NRSRO's registration for violations of any rule adopted under

53 15 U.S.C. 78o-7(h)(3)(B)(ii).

54 See id.

Section 15E(h).[55] Moreover, the Commission notes that Section 15E(h)(3)(B)(ii) does not require that the violation of the rule be "willful."[56]

Currently, the Commission can seek to suspend or revoke the registration of an NRSRO, in addition to other potential sanctions, under Section 15E(d) of the Exchange Act.[57] In particular, Section 15E(d) provides that the Commission shall, by order, censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO if the Commission finds, "on the record after notice and opportunity for a hearing," that such sanction is "necessary for the protection of investors and in the public interest" and the NRSRO, or a person associated with the NRSRO, has engaged in one or more of six categories of conduct.[58] The first category is that the NRSRO or an associated person has: committed or omitted any act, or has been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of Section 15(b)(4) of the Exchange Act; has been convicted of any offense identified in Section 15(b)(4)(B) of the Exchange Act; or has been enjoined from any action, conduct, or practice identified in Section 15(b)(4)(C) of the Exchange Act.[59] The acts enumerated in Section 15(b)(4)(D) of the Exchange Act include that the person has willfully violated any provision of the Exchange Act or the rules or regulations under the Exchange Act.[60] Therefore, the Commission has the ability, under Section 15E(d), to suspend or revoke the registration of an NRSRO for a willful violation of

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55 Id.

56 Id.

57 See 15 U.S.C. 78o-7(d).

58 15 U.S.C. 78o-7(d).

59 See 15 U.S.C. 78o-7(d)(1)(A); see also 15 U.S.C. 78o(b)(4)(A), (B), (C), (D), (E), (G), and (H).

60 15 U.S.C. 78o(b)(4)(D).

Rule 17g-5, but does not have the power to do so under Section 15E(d) for violations of Rule 17g-5 that are not willful.[61]

The Commission preliminarily believes a rule implementing Section 15E(h)(3)(B)(ii) of the Exchange Act should work in conjunction with Sections 15E(d) and 21C of the Exchange Act.[62] Specifically, proposed new paragraph (g) of Rule 17g-5 would provide that in a proceeding pursuant to Section 15E(d) or Section 21C of the Exchange Act, the Commission shall suspend or revoke the registration of an NRSRO if the Commission finds in such proceeding that the NRSRO has violated a rule issued under Section 15E(h) of the Exchange Act, the violation affected a rating, and that suspension or revocation is necessary for the protection of investors and in the public interest.[63] The Commission preliminarily believes this provision is appropriately placed in Rule 17g-5 given that it is the predominant rule issued under Section 15E(h) of the Exchange Act.[64]

The first two proposed findings in proposed paragraph (g) of Rule 17g-5 would mirror the text of Section 15E(h)(3)(B)(ii) of the Exchange Act.[65] The final finding – that the

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61 See 15 U.S.C. 78o-7(d)(1)(A) and 15 U.S.C. 78o(b)(4)(D).

62 15 U.S.C. 78o-7(d) and 15 U.S.C. 78u-3.

63 See proposed new paragraph (g) of Rule 17g-5; see also 15 U.S.C. 78o-7(d) and (h), and 78u-3. Section 21C of the Exchange Act provides the Commission with authority, among other things, to enter an order requiring, among other things, that a person cease-and-desist from continuing to violate, or future violations of, a provision of the Exchange Act or any rule or regulation thereunder. Proposed paragraph (g) of Rule 17g-5 would provide that the Commission can issue an order in a cease-and-desist proceeding suspending or revoking the registration of an NRSRO. Id.

64 See, e.g., Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33595-33599 (June 18, 2007), Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6465-6469 (Feb. 9, 2009), and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63842-63850 (Dec. 4, 2009).

65 Compare the first two findings in proposed new paragraph (g) of Rule17g-5 (that the NRSRO has violated a rule issued under Section 15E(h) of the Act; and the violation

suspension or revocation is necessary for the protection of investors and in the public interest – is a common finding that the Commission must make to take disciplinary action against a registered person or entity.[66] It is not, however, a finding that the Commission must make in a proceeding under Section 21C.[67] Further, unlike Section 15E(d) of the Exchange Act, the Commission can take action under Section 21C for violations of the securities laws even if such violations are not willful.[68] Moreover, Section 15E(h)(3)(B)(ii) of the Exchange Act does not prescribe the maximum amount of time for which an NRSRO could be suspended, whereas Section 15E(d) provides that a suspension shall not exceed 12 months.[69] Consequently, a proceeding pursuant to paragraph (g) of Rule 17g-5 brought under Section 21C could result in a suspension that exceeds 12 months. Given that Section 21C of the Exchange Act has a lower threshold for the intent to establish a violation, and given the substantial consequences of suspending or revoking a registration, the Commission preliminarily believes that the public interest finding would be an appropriate predicate to a suspension or revocation of an NRSRO's registration under Section 21C of the Exchange Act.

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (g) of Rule 17g-5. The Commission also seeks comment on the following:

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affected a rating) with Sections 15E(h)(3)(B)(ii)(I) and (II) of the Exchange Act, respectively. 15 U.S.C. 78o-7(h)(3)(B)(ii)(I) and (II).

66 For example, the Commission must make this finding to take action under Section 15E(d) of the Exchange Act. See 15 U.S.C. 78o-7(d).

67 See 15 U.S.C. 78u-3.

68 Compare 15 U.S.C. 78o-7(d) and 15 U.S.C. 78u-3.

69 Compare 15 U.S.C. 78o-7(h)(3)(B)(ii) and 15 U.S.C. 78o-7(d).

1. Should the Commission propose, pursuant to Section 15E(h)(3)(B)(ii) of the Exchange Act, an independent and alternative process for suspending or revoking an NRSRO's registration for a violation of a rule issued under Section 15E(h) (i.e., a proceeding that is not pursuant to Sections 15E(d) and 21C of the Exchange Act)? If so, how should such a separate proceeding operate? For example, should it require the same findings proposed above or alternative or additional findings?
2. In terms of the finding that "the violation affected a rating," what type of factual predicate should support such a finding? For example, would it be appropriate to make such a finding if the Commission determined that the violation caused the NRSRO to issue a credit rating that was not based solely on its documented procedures and methodologies for determining credit ratings (e.g., the Commission finds that undue influence impacted the credit rating assigned to the rated obligor, security, or money market instrument because strictly adhering to the procedures and methodologies would have resulted in the NRSRO issuing a credit rating at a lower or higher notch in the applicable rating scale)?
3. With respect to proposed new paragraph (g) of Rule 17g-5, should the proposed rule include additional or alternative findings that the Commission would need to make to revoke or suspend the registration of an NRSRO in a proceeding under Sections 15E(d) or 21C? If so, what should those findings be? For example, should the Commission need to find that the violation harmed investors or other users of credit ratings?
4. Should the Commission, as proposed, require a public interest finding in order to suspend or revoke an NRSRO's registration in a proceeding under paragraph (g) of Rule 17g-5 pursuant to Section 21C, or should the rule provide for the suspension or revocation of an

NRSRO's registration solely based on a finding that a violation of a rule affected a rating?

5. With respect to proposed new paragraph (g) of Rule 17g-5, should the rule incorporate only Section 15E(d) of the Exchange Act? If so, why? Alternatively, should it incorporate only Section 21C of the Exchange Act? If so, why?

6. As noted above, there would be no limit on the amount of time for which the Commission could suspend the registration of an NRSRO in a proceeding under Section 21C of the Exchange Act and proposed paragraph (g) of Rule 17g-5. Should the Commission add such a time limit to be consistent with Section 15E(d) of the Exchange Act? Alternatively, does the different standard provide the Commission with appropriate flexibility to seek longer suspensions?

### C. "LOOK-BACK" REVIEW

Section 932(a)(4) of the Dodd-Frank Act amended Section 15E(h) of the Exchange Act to add a new paragraph (4).[70] The Commission is proposing to implement rulemaking required in Section 15E(h)(4)(A)(ii) of the Exchange Act through proposed paragraph (c) of new Rule 17g-8.[71] In addition, the Commission is proposing to amend Rule 17g-2 to apply that rule's record retention and production requirements to the policies and procedures required pursuant to

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70 See Pub. L. No. 111-203 § 932(a)(4) and 15 U.S.C. 78o-7(h)(4).

71 New Rule 17g-8 would be codified at 17 CFR 240.17g-8, if adopted. In addition, new Rule 17g-8, as proposed, would consolidate requirements that NRSROs have policies and procedures in a number of areas. As discussed below in Section II.F.1 of this release, proposed paragraph (a) of new Rule 17g-8 would require an NRSRO to establish policies and procedures with respect to credit rating methodologies. In addition, as discussed below in Section II.J.1 of this release, proposed paragraph (b) of new Rule 17g-8 would require an NRSRO to establish policies and procedures with respect to the use of credit rating symbols, numbers, and scores. And, as discussed in this section of the release, the Commission is proposing to implement rulemaking specified in Section 15E(h)(4)(A)(ii) of the Exchange Act (15 U.S.C. 78o-7(h)(4)(A)(ii)), in part, by proposing paragraph (c) of new Rule 17g-8.

the self-executing provisions in Section 15E(h)(4)(A) of the Exchange Act and pursuant to proposed paragraph (c) of new Rule 17g-8.[72]

### 1. Proposed Paragraph (c) of New Rule 17g-8

Sections 15E(h)(4)(A)(i) and (ii) of the Exchange Act require an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to ensure that, in any case in which an employee of a person subject to a credit rating of the NRSRO or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the NRSRO, was employed by the NRSRO and participated in any capacity in determining credit ratings for the person or the securities or money market instruments during the 1-year period preceding the date an action was taken with respect to the credit rating, the NRSRO shall: (1) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating (a "look-back review"); and (2) take action to revise the rating if appropriate, <u>in accordance with such rules as the Commission shall prescribe</u>.[73] Consequently, Section 15E(h)(4)(A)(i) of the Exchange Act contains a self-executing provision requiring an NRSRO to establish, maintain, and enforce policies and procedures as described above to conduct look-back reviews, and Section 15E(h)(4)(ii) contains a provision mandating Commission rulemaking with respect to requirements for an NRSRO to revise a credit rating in certain circumstances.[74]

The Commission proposes to implement the rulemaking required in Section 15E(h)(4)(A)(ii) of the Exchange Act by proposing paragraph (c) of new Rule 17g-8.[75] Proposed paragraph (c) would require that the policies and procedures the NRSRO establishes, maintains,

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72 <u>See</u> 15 U.S.C. 78o-7(h)(4)(A), proposed paragraph (c) of new Rule 17g-8, and proposed new paragraph (a)(9) of Rule 17g-2.

73 <u>See</u> 15 U.S.C. 78o-7(h)(4)(A)(i) and (ii) (emphasis added).

74 <u>Id.</u>

75 <u>See</u> proposed paragraph (c) of new Rule 17g-8 and 15 U.S.C. 78o-7(h)(4)(A)(ii).

and enforces pursuant to Section 15E(h)(4)(A) of the Exchange Act must address instances in which a review conducted pursuant to those policies and procedures determines that a conflict of interest influenced a credit rating assigned to an obligor, security, or money market instrument by including, at a minimum, procedures that are reasonably designed to ensure the NRSRO will: (1) immediately place the credit rating on credit watch; (2) promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest and is solely the product of the NRSRO's documented procedures and methodologies for determining credit ratings; and (3) promptly publish a revised credit rating, if appropriate, or affirm the credit rating if appropriate.[76]

The Commission acknowledges that Section 15E(c)(2) of the Exchange Act provides, in pertinent part, that the Commission may not regulate the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings.[77] The Commission preliminarily believes that the steps described above would not regulate the procedures and methodologies by which an NRSRO determines credit ratings because the NRSRO would apply its own procedures and methodologies to determine whether the credit rating should be revised. Moreover, the placement of a credit rating on credit watch is not a determination of a credit rating (i.e., it does not change the credit rating) but rather is a means of providing notice to users of the NRSRO's credit ratings that an active evaluation of the credit rating is underway. For these reasons, the Commission preliminarily believes that the approach in proposed paragraph (c) of new Rule 17g-8 appropriately avoids regulating the substance of credit ratings or the procedures and methodologies an NRSRO uses to determine credit ratings but, at the same time, requires an NRSRO to have procedures reasonably designed to ensure that

76 See proposed paragraphs (c)(1), (2) and (3) of new Rule 17g-8.

77 15 U.S.C. 78o-7(c)(2).

it immediately provides notification and promptly address a credit rating that is influenced by a conflict of interest.[78] The Commission also preliminarily believes that the actions prescribed in proposed paragraph (c) of new Rule 17g-8 are steps a prudent NRSRO would take in the normal course when discovering a conflict of interest influenced the determination of a credit rating. Nonetheless, the Commission is soliciting comment on these issues below.

Proposed paragraph (c)(1) of new Rule 17g-8 would require the NRSRO to have procedures reasonably designed to ensure that, upon the NRSRO's discovery of the conflict, it immediately publishes a rating action placing the applicable credit ratings of the obligor, security, or money market instrument on credit watch or review.[79] When an NRSRO publishes a rating action indicating the current credit rating assigned to an obligor, security, or money market instrument (or a class of obligors, securities, or money market instruments) is on credit watch or under review, the purpose is to notify users of the NRSRO's credit ratings that the credit rating is undergoing a process of evaluation that may result in it being upgraded or downgraded.[80] The Commission preliminarily believes an NRSRO should have policies and procedures reasonably designed to ensure that the users of its credit ratings are provided immediate notice of the discovery that a conflict influenced a credit rating assigned to an obligor, security, or money

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78 The Commission also notes an NRSRO would, among other things, violate Section 15E(h)(1) of the Exchange Act and Rule 17g-5, among other rules, if it continued to assign an obligor, security, or money, market instrument a credit rating that, absent the undue influence of the conflict of interest, would be different because the NRSRO could not be deemed to have policies and procedures reasonably designed to address and manage conflicts of interest that can arise from its business under such a circumstance. See 15 U.S.C. 78o-7(h) and 17 CFR 17g-5.

79 See proposed paragraph (c)(1) of new Rule 17g-8.

80 For example, an NRSRO may place a credit rating on negative credit watch, which means it is evaluating whether to downgrade the credit rating, or on positive credit watch, which means it is evaluating whether to upgrade the credit rating.

market instrument. The Commission also preliminarily believes an effective means of providing such notice would be to place the obligor, security, or money market instrument on credit watch.

Proposed paragraph (c)(1) of new Rule 17g-8 also would provide that the policies and procedures must be reasonably designed to ensure the NRSRO includes the information required by paragraph (a)(1)(ii)(J)(3)(i) of Rule 17g-7 with the publication of the rating action placing the credit rating of the obligor, security, or money market instrument on credit watch.[81] As discussed below in Section II.G of this release, the Commission is proposing to implement Section 15E(s) of the Exchange Act, in part, by requiring, in proposed new paragraph (a) of Rule 17g-7, that an NRSRO generate a form to be included with the publication of a credit rating.[82] Proposed paragraph (a) of Rule 17g-7, among other things, would prescribe certain qualitative and quantitative information that must be disclosed in the form.[83] The Commission is proposing that the qualitative information in the form include certain disclosures that would need to be made if the rating action results from a look-back review conducted pursuant to Section 15E(h)(4)(A)(i) of the Exchange Act and proposed paragraph (c) of new Rule 17g-8.[84] Specifically, when a credit rating is placed on credit watch, proposed new paragraph (a)(1)(ii)(J)(3)(i) of Rule 17g-7 would require the NRSRO to provide in the form published with the rating action an explanation that the reason for the action is the discovery that a credit rating assigned to the obligor, security, or money market instrument in one or more prior rating actions was influenced by a conflict of interest and the date and associated credit rating of each prior

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81 Id.; see also proposed new paragraph (a)(1)(ii)(J)(3)(i) of Rule 17g-7.

82 See 15 U.S.C. 78o-7(s) and proposed new paragraph (a) of Rule 17g-7.

83 See proposed new paragraphs (a)(1)(ii)(A)-(N) of Rule 17g-7.

84 See proposed new paragraphs (a)(1)(ii)(J)(3)(i)-(iii) of Rule 17g-7 and related discussion below in Section II.G.3 of the release.

rating action the NRSRO currently has determined was influenced by the conflict.[85] This would alert users of the NRSRO's credit ratings that the credit rating assigned to the obligor, security, or money market instrument might be revised to address a conflict of interest and would identify the prior rating action or actions the NRSRO has determined were influenced by the conflict. With respect to identifying the prior rating actions, the Commission is proposing that the rule require the NRSRO to provide the date and associated credit rating of such actions the NRSRO "currently has determined" were influenced by the conflict.[86] The Commission's proposed use of the term "currently" is designed to conform to the requirement of proposed paragraph (c)(1) of Rule 17g-8 that the NRSRO have procedures designed to place the credit rating of the obligor, security, or money market instrument on credit watch immediately upon the discovery that a conflict influenced a prior credit rating action (i.e., not wait until the NRSRO has determined whether additional credit ratings previously assigned to the obligor, security, or money market instrument also were influenced by the conflict). The Commission preliminarily believes that the best approach would be to alert users of the NRSRO's credit ratings as soon as possible after a conflict is discovered.

Proposed paragraph (c)(2) of new Rule 17g-8 would require the NRSRO to have procedures reasonably designed to ensure it promptly determines whether the current credit rating assigned to the obligor, security, or money market instrument must be revised so that it no longer is influenced by a conflict of interest and is solely a product of the documented procedures and methodologies the NRSRO uses to determine credit ratings.[87] The goal would be to ensure as quickly as possible that the credit rating assigned to the obligor, security, or money

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85 See proposed new paragraph (a)(1)(ii)(J)(3)(i) of Rule 17g-7.

86 Id.

87 See proposed paragraph (c)(2) of new Rule 17g-8.

market instrument is solely a product of the NRSRO's procedures and methodologies for determining credit ratings (i.e., is in no way influenced by the conflict). With respect to making this determination, the Commission preliminarily believes one approach would be to apply de novo the NRSRO's procedures and methodologies for determining credit ratings to the rated obligor, security, or money market instrument and revise the current credit rating if the de novo application produces a credit rating at a different notch on the rating scale.

The Commission does not expect an NRSRO would revise a credit rating in every circumstance in which an earlier rating action was influenced by a conflict of interest. The Commission preliminarily notes that Section 15E(h)(4)(A)(ii) of the Exchange Act provides that the NRSRO's policies and procedures shall be reasonably designed to, among other things, ensure that the NRSRO takes action to revise the credit rating "if appropriate."[88] It is possible, for example, that in the period since the NRSRO published the conflicted credit rating events unrelated to the conflict occurred that when factored into a de novo application of the NRSRO's procedures and methodologies for determining credit ratings would produce a credit rating at the same notch in the rating scale as the credit rating that was influenced by the conflict.[89] The Commission preliminarily believes a requirement that the NRSRO nonetheless revise the credit

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88 15 U.S.C. 78o-7(h)(4)(A)(ii).

89 For example, assume that nine months ago an analyst upgraded the credit rating assigned to an issuer's securities from BBB to AA. The analyst leaves the NRSRO to work for the issuer. The analyst's new employment triggers a look-back review of the rating action upgrading the credit rating from BBB to AA pursuant to Section 15E(h)(4)(A)(i) of the Exchange Act. The look-back review determines the credit rating should not have been upgraded from BBB to AA at that point in time and the analyst's action in upgrading the credit rating was influenced by the prospect of employment with the issuer. The NRSRO performs a de novo review of the credit rating assigned to the issuer by applying its procedures and methodologies for determining credit ratings. This review – as required by the procedures and methodologies – takes into consideration favorable financial results the issuer reported three months ago. Consequently, the process of re-rating the issuer's securities determines the current credit rating should be AA.

rating could interfere with the NRSRO's procedures and methodologies for determining credit ratings in that it would force the NRSRO to change the credit rating assigned to the obligor, security, or money market instrument to a different notch in the rating scale than would be the case if the credit rating were solely a product of the NRSRO's procedures and methodologies. Consequently, a mandatory revision requirement could, in effect, require the NRSRO to publish a credit rating that was inaccurate from the perspective of those procedures and methodologies.

Proposed paragraph (c)(3) of new Rule 17g-8 would require that the NRSRO have procedures reasonably designed to ensure it promptly publishes a revised credit rating, if appropriate, or an affirmation of the credit rating, if appropriate, based on the determination of whether the current credit rating assigned to the obligor, security, or money market instrument must be revised.[90] The Commission's intent is for the NRSRO to have procedures that are reasonably designed to notify users of the NRSRO's credit ratings as quickly as possible, whether the credit rating assigned to the obligor, security, or money market instrument will be changed or remain the same.[91] The goal would be to promptly remove the uncertainty surrounding the credit rating to limit the potential that investors and other users of credit ratings might make investment or other credit based decisions based on incomplete information.

As with the placement of the credit rating on credit watch, proposed paragraph (c)(3) of new Rule 17g-8 would require that the NRSRO's procedures would need to be reasonably designed to ensure that information required pursuant to proposed new paragraph

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[90] See proposed paragraphs (c)(3)(i) and (ii) of new Rule 17g-8; see also proposed new paragraphs (a)(1)(ii)(J)(3)(ii) and (iii) of Rule 17g-7.

[91] The Commission notes that, in the case of an NRSRO that makes its rating actions available only to subscribers, former subscribers who made an investment or other credit based decision using the credit rating likely would not receive notice that the credit rating was influenced by a conflict of interest as well as any changes made to the credit rating as a result of the "look-back" review.

(a)(1)(ii)(J)(3)(ii) and (iii) of Rule 17g-7, respectively, is included with the publication of a revised or affirmed credit rating.[92] In the case of a revised rating, proposed new paragraph (a)(1)(ii)(J)(3)(ii) of Rule 17g-7 would require the NRSRO to provide in the form published with the rating action an explanation that the reason for the action is the discovery that a credit rating assigned to the obligor, security, or money market instrument in one or more prior rating actions was influenced by a conflict of interest, the date and associated credit rating of each prior rating action the NRSRO has determined was influenced by the conflict, and an estimate of the impact the conflict had on each such prior rating action.[93] Similarly, in the case of an affirmed rating, proposed new paragraph (a)(1)(ii)(J)(3)(iii) of Rule 17g-7 would require the NRSRO to provide an explanation of why no rating action was taken to revise the credit rating notwithstanding the conflict, the date and associated credit rating of each prior rating action the NRSRO has determined was influenced by the conflict, and an estimate of the impact the conflict had on each such prior rating action.[94]

As indicated in the proposed disclosures, the NRSRO would need to include an estimate of the impact the conflict had on each prior rating action influenced by the conflict.[95] The Commission preliminarily believes one approach an NRSRO could take to making such an estimate would be to apply de novo its procedures and methodologies for determining credit ratings to the rated obligor, security, or money market instrument using information and inputs as of the time period for which it was determined that the credit rating was influenced. In other words, under this approach the NRSRO would reconstruct the past rating action through a

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92 See proposed paragraphs (c)(3)(i) and (ii) of new Rule 17g-8.

93 See proposed new paragraph (a)(1)(ii)(J)(3)(ii) of Rule 17g-7.

94 See proposed new paragraph (a)(1)(ii)(J)(3)(iii) of Rule 17g-7.

95 See proposed paragraph (c)(2)(i) of new Rule 17g-8; see also proposed paragraph (c)(2)(ii) of Rule 17g-8.

"conflict-free" application of its procedures and methodologies for determining credit ratings. The NRSRO then could compare the credit ratings and disclose the difference between the rating action that was influenced by a conflict and the reconstructed rating action.

The disclosures required by proposed new paragraphs (a)(1)(ii)(J)(3)(i), (ii) and (iii) of Rule 17g-7 would alert users of the NRSRO's credit ratings that the rating action was taken because a conflict of interest had influenced one or more credit ratings assigned to the obligor, security, or money market instrument.[96] In addition, the estimate of the impact of the conflict would provide users of the NRSRO's credit ratings with a sense of the magnitude of the variation between the credit rating influenced by the conflict and the credit rating that would have been determined had the conflict not existed. The users of the NRSRO's credit ratings could consider this information in evaluating the ability of the NRSRO to manage conflicts of interest in the production of credit ratings. Moreover, if the variation between the credit rating influenced by the conflict and the "un-conflicted" credit rating was large (e.g., 2 or 3 notches in the applicable rating scale), users of the NRSRO's credit ratings could consider the potential risk of using the NRSRO's credit ratings to make investment or other credit-based decisions (particularly if the revision downgraded the credit rating to a low category in the rating scale).

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (c) of new Rule 17g-8. The Commission also seeks comment on the following:

1. Would the requirements to have procedures reasonably designed to ensure the NRSRO takes the steps set forth in proposed paragraphs (c)(1), (2), and (3) of new Rule 17g-8 alter the procedures and methodologies an NRSRO uses to determine credit ratings? For

96 See proposed paragraphs (a)(1)(ii)(J)(3)(i), (ii) and (iii) of Rule 17g-7.

example, would an NRSRO take materially different steps if a look-back review conducted pursuant to Section 15E(h)(4)(A) of the Exchange Act determined that a credit rating was influenced by a conflict of interest? If so, describe in detail how those steps would differ.

2. Under Section 15E(h)(4)(A)(i) of the Exchange Act, an NRSRO must, in certain circumstances conduct a review to determine whether any conflicts of interest of an employee influenced the credit rating. Should the Commission define what it means to have a conflict of interest "influence" a credit rating? If so, how should this term be defined? For example, should a credit rating be deemed "influenced" if the NRSRO would have taken a different rating action with respect to the credit rating in the absence of the conflict?

3. How would an NRSRO determine whether this conflict influenced a credit rating? Describe the types of evidence that would support such a determination. What steps could an NRSRO take to analyze whether this conflict influenced a credit rating? Are there any practical issues with respect to making such a determination? If so, describe them.

4. Is there any reason an NRSRO should not have procedures reasonably designed to ensure it immediately publishes a rating action placing the obligor, security, or money market instrument on credit watch based on the discovery of the conflict and include with the publication of the rating action the information required by proposed new paragraph (a)(1)(ii)(J)(3)(i) of Rule 17g-7 as would be required by proposed paragraph (c)(1) of Rule 17g-8? If so, please explain in detail the rationale for not disclosing this information immediately in this manner. In addition, if a commenter agrees with the

objective of the requirement but not the manner of disclosure, describe any alternative means of disclosure that would achieve the objective.

5. What practical issues should the Commission consider in implementing proposed paragraph (c)(1) of new Rule 17g-8? How could the proposal be modified to address any practical issues identified without undermining the objectives of the proposal?
6. Would the information required by proposed new paragraph (a)(1)(ii)(J)(3)(i) of Rule 17g-7 to be included in the form published with a rating action placing the obligor, security, or money market instrument on credit watch be useful to the users of the NRSRO's credit ratings? Is there additional or alternative information that should be provided? If so, please describe such additional or alternative information.
7. Is there any reason an NRSRO would not have procedures reasonably designed to ensure it promptly determines whether the current credit rating assigned to the obligor, security, or money market instrument must be revised so it no longer is influenced by a conflict of interest and is solely a product of the documented procedures and methodologies the NRSRO uses to determine credit ratings as would be required pursuant to proposed paragraph (c)(2) of new Rule 17g-8? If so, please explain in detail the rationale for not promptly making such a determination. In addition, are there alternative approaches to addressing conflicts of interest influencing credit ratings that the Commission should consider? If so, please identify and describe them.
8. What practical issues should the Commission consider in implementing proposed paragraph (c)(2) of new Rule 17g-8? How could the proposal be modified to address any practical issues identified without undermining the objectives of the proposal?

9. Should the Commission be more prescriptive in terms of how an NRSRO would be required to determine whether the current credit rating assigned to the obligor, security, or money market instrument must be revised so it no longer is influenced by a conflict of interest and is solely a product of the documented procedures and methodologies the NRSRO uses to determine credit ratings? If so, what actions should the Commission require be included in the NRSRO's policies and procedures? For example, should the Commission specifically require the NRSRO to apply de novo its policies and procedures for determining credit ratings in the ways described above?

10. Would a de novo application of the NRSRO's policies and procedures for determining credit ratings be sufficient to address the conflict of interest? Are there alternative or additional approaches to determining whether a credit rating influenced by a conflict of interest should be revised?

11. Is there any reason an NRSRO should not have procedures reasonably designed to ensure that it promptly publishes, as applicable, a revised credit rating or an affirmation of the current credit rating based on the determination of whether the current credit rating assigned to the obligor, security, or money market instrument must be revised and include with the rating action the information required by proposed new paragraphs (a)(1)(ii)(J)(3)(ii) or (iii) of Rule 17g-7, as applicable, as would be required pursuant to paragraph (c)(3) of new Rule 17g-8? If so, please explain in detail the rationale for not promptly revising or affirming the current credit rating.

12. What practical issues should the Commission consider in implementing proposed paragraph (c)(3) of new Rule 17g-8 that would require an NRSRO to have procedures reasonably designed to ensure that it promptly publishes, as appropriate, a revised credit

rating or an affirmation of the current credit rating and includes with the rating action the information required by proposed new paragraphs (a)(1)(ii)(J)(3)(ii) and (iii) of Rule 17g-7? For example, would the requirement to estimate the impact the conflict had on the prior rating actions substantially prolong the time between placing the credit rating on credit watch and either publishing a revised credit rating or affirming the current credit rating? How could the proposal be modified to address any practical issues identified without undermining the objective of promptly addressing a credit rating influenced by a conflict of interest and at the same time providing investors and other users of credit ratings with the information about the conflict?

13. In terms of estimating the impact of a conflict on a past rating action, would a feasible approach be to apply de novo the procedures and methodologies for determining credit ratings to the relevant obligor, security, or money market instrument using information and inputs as of the time period in which the conflicted credit rating was determined? Would this approach result in a meaningful estimate? Are there alternative or additional steps that could be taken to estimate the impact?

14. Would the information required by proposed new paragraphs (a)(1)(ii)(J)(3)(ii) and (iii) of Rule 17g-7 to be included in the form published with a revised or affirmed credit rating, respectively, be useful to the users of the NRSRO's credit ratings? Is there additional or alternative information that should be provided? If so, please describe such additional or alternative information.

15. How would the proposals impact obligors and issuers subject to a credit rating determined through the "look-back" review to be influenced by the conflict of interest?

16. In the case of an NRSRO that only makes its rating actions available to subscribers, former subscribers likely would not receive the proposed notices. Does this raise a significant issue that the Commission should address? If so, describe alternatives that could be used to address this issue.

### 2. Proposed Amendment to Rule 17g-2

Section 15E(h)(4)(A) of the Exchange Act requires an NRSRO "to establish, maintain, and enforce policies and procedures" but does not explicitly require an NRSRO to "document" such policies and procedures.[97] Nonetheless, the Commission preliminarily believes that documenting these policies and procedures is necessary in order to carry out the statute's mandate. The Commission also preliminarily believes they should be documented because, among other reasons, it is a sound practice for any organization to document its policies and procedures to promote better understanding of them among the individuals within the organization and thereby to promote compliance with such policies and procedures. In addition, for the reasons discussed in Section II.A.2 of this release, the Commission preliminarily believes that the policies and procedures should be subject to the same recordkeeping requirements that apply to other records an NRSRO is required to retain pursuant to Rule 17g-2.[98] For these reasons, the Commission proposes adding paragraph (a)(9) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Exchange Act and paragraph (c) of Rule 17g-8 as a record an NRSRO must make and retain.[99] As a result, the policies and procedures would need to be documented in

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97 See 15 U.S.C. 78o-7(h)(4)(A).

98 17 CFR 240.17g-2.

99 See proposed new paragraph (a)(9) to Rule 17g-2; see also Section 17(a)(1) of the Exchange Act, which requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or

writing and be subject to the record retention and production requirements in paragraphs (c) through (f) of Rule 17g-2.[100]

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (a)(9) of Rule 17g-2.

### D. FINES AND OTHER PENALTIES

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new subsection (p), which contains four paragraphs: (1), (2), (3), and (4).[101] Section 15E(p)(4)(A) provides that the Commission shall establish, by rule, fines and other penalties applicable to any NRSRO that violates the requirements of Section 15E of the Exchange Act and the rules under the Exchange Act.[102]

The Exchange Act already provides a wide range of fines, penalties, and other sanctions applicable to NRSROs for violations of any section of the Exchange Act (including Section 15E) and the rules under the Exchange Act (including the rules under Section 15E).[103] For example, Section 15E(d)(1) of the Exchange Act provides that the Commission shall censure an NRSRO, place limitations on the activities, functions, or operations of an NRSRO, suspend an NRSRO for a period not exceeding 12 months, or revoke the registration of an NRSRO if, among other reasons, the NRSRO violates Section 15E of the Exchange Act or the Commission's rules

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appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. 15 U.S.C. 78q(a)(1).

100 See 17 CFR 240.17g-2(c)-(f).

101 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(p)(1)-(4).

102 See 15 U.S.C. 78o-7(p)(4)(A).

103 See 15 U.S.C. 78o-7(d), 15 U.S.C. 78u, 15 U.S.C. 78u-1, 15 U.S.C. 78u-2, 15 U.S.C. 78u-3 and 15 U.S.C. 78ff.

thereunder.[104] In addition, Section 932(a)(3) of the Dodd-Frank Act amended Section 15E(d) to explicitly provide additional potential sanctions.[105] First, it provided the Commission with the authority to seek sanctions against persons associated with, or seeking to become associated with, an NRSRO.[106] Under these amendments, the Commission can censure such persons, place limitations on the activities or functions of such persons, suspend such persons for a period not exceeding 1 year, or bar such persons from being associated with an NRSRO.[107] Second, Section 932(a)(3) of Dodd-Frank Act amended Section 15E(d) to provide the Commission with explicit authority to temporarily suspend or permanently revoke the registration of an NRSRO in a particular class or subclass of credit ratings if the NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.[108]

Furthermore, Sections 21, 21A, 21B, 21C, and 32 of the Exchange Act provide additional means to sanction an NRSRO for violations of the provisions of the Exchange Act such as the self-executing provisions in Section 15E of the Exchange Act and the rules under the Exchange Act.[109]

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104 See Section 15E(d)(1)(A)-(F) of the Exchange Act (15 U.S.C. 78o-7(d)(1)(A)-(F)), as amended by the Dodd-Frank Act.

105 See Pub. L. No. 111-203 § 932(a)(3) and 15 U.S.C. 78o-7(d).

106 15 U.S.C. 78o-7(d)(1).

107 Id.

108 See Pub. L. No. 111-203 § 932(a)(3) and 15 U.S.C. 78o-7(d)(2). Prior to this amendment, the Commission already had authority to suspend or revoke the registration of an NRSRO if it failed to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity. See Section 15E(d)(5) of the Exchange Act (15 U.S.C 78o-7(d)(5)) before being amended by the Dodd-Frank Act, which re-designated paragraph (d)(5) of Section 15E as paragraph (d)(1)(E) (15 U.S.C 78o-7(d)(1)(E)). Section 15E(d)(2) of the Exchange Act, however, provides explicit authority to target a suspension or registration revocation to a specific class or subclass of security. See 15 U.S.C. 78o-7(d)(2).

109 See 15 U.S.C. 78o-7, 15 U.S.C. 78u, 15 U.S.C. 78u-1, 15 U.S.C. 78u-2, 15 U.S.C. 78u-3

The Commission preliminarily believes these provisions of the Exchange Act, as amended by the Dodd-Frank Act, provide a sufficiently broad range of means to impose fines, penalties, and other sanctions on an NRSRO for violations of Section 15E of the Exchange Act and the rules thereunder. For example, the fines, penalties, and sanctions applicable to NRSROs are similar in scope to the fines, penalties, and sanctions applicable to other registrants under the Exchange Act, such as broker-dealers. Moreover, since enactment of the Rating Agency Act of 2006, the Commission has not identified a specific need for a fine or penalty applicable to NRSROs not otherwise provided for in the Exchange Act. Consequently, the Commission preliminarily believes it would be appropriate at this time to defer establishing new fines or penalties in addition to those provided for in the Exchange Act. However, in the future, the Commission may use the authority in Section 15E(p)(4)(A) of the Exchange Act if a specific need is identified. For the foregoing reasons, to implement Section 15E(p)(4)(A) of the Exchange Act at this time, the Commission proposes to amend the instructions to Form NRSRO by adding new Instruction A.10.[110] This new instruction would provide notice to credit rating agencies applying for registration and NRSROs that an NRSRO is subject to applicable fines, penalties, and other available sanctions set forth in Sections 15E, 21, 21A, 21B, 21C, and 32 of the Exchange Act (15 U.S.C. 78o-7, 78u, 78u-1, 78u-2, 78u-3, and 78ff, respectively) for violations of the securities laws.

Request for Comment

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and 15 U.S.C. 78ff, respectively. In fact, the Dodd-Frank Act amended Section 21B of the Exchange Act (15 U.S.C. 78u-2) to provide the Commission with the authority to assess money penalties in cease and desist proceedings under Section 21C (15 U.S.C. 78u-3). See Section 929P(a)(2) of the Dodd-Frank Act.

110 See proposed new Instruction A.10 to Form NRSRO.

The Commission generally requests comment on all aspects of proposed new Instruction A.10 to Form NRSRO. The Commission also seeks comment on the following:

1. Are the fines, penalties and other sanctions applicable to NRSROs in Sections 15E, 21, 21A, 21B, 21C, and 32 of the Exchange Act sufficient? If not, what additional fines and penalties should the Commission establish by rule?

## E. PUBLIC DISCLOSURE OF INFORMATION ABOUT THE PERFORMANCE OF CREDIT RATINGS

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new subsection (q), which contains paragraphs (1) and (2).[111] Section 15E(q)(1) provides that the Commission shall, by rule, require each NRSRO to publicly disclose information on the initial credit ratings determined by the NRSRO for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.[112] Section 15E(q)(2) provides that the Commission's rules shall require, at a minimum, disclosures that:

- are comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs;[113]
- are clear and informative for investors having a wide range of sophistication who use or might use credit ratings;[114]
- include performance information over a range of years and for a variety of types of credit ratings, including for credit ratings withdrawn by the NRSRO;[115]

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111 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(q)(1) and (2).

112 See 15 U.S.C. 78o-7(q)(1).

113 See 15 U.S.C. 78o-7(q)(2)(A).

114 See 15 U.S.C. 78o-7(q)(2)(B).

- are published and made freely available by the NRSRO, on an easily accessible portion of its website, and in writing, when requested;[116]
- are appropriate to the business model of an NRSRO;[117] and
- require an NRSRO to include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.[118]

Currently, the Commission's rules require NRSROs to publish two types of information about the performance of their credit ratings: (1) performance statistics[119] and (2) ratings histories.[120] As discussed in detail below, the Commission proposes to implement the

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115 See 15 U.S.C. 78o-7(q)(2)(C).

116 See 15 U.S.C. 78o-7(q)(2)(D).

117 See 15 U.S.C. 78o-7(q)(2)(E).

118 See 15 U.S.C. 78o-7(q)(2)(F). As discussed below in Section II.G.4 of this release, the Commission preliminarily believes that the attestation requirement specified in Section 15E(q)(2)(F) should be incorporated into the rule the Commission is proposing to implement Section 15E(s) of the Exchange Act, which specifies, among other things, that the Commission adopt rules requiring an NRSRO to generate a form to be included with the publication of a credit rating. See 15 U.S.C. 78o-7(s) and proposed new paragraph (a)(1)(iii) of Rule 17g-7.

119 See Exhibit 1 to Form NRSRO and Instruction H to Form NRSRO (as it relates to Exhibit 1). This type of disclosure shows the performance of an NRSRO's credit ratings in the aggregate through statistics. Specifically, it provides the percent of rated obligors, securities, and money market instruments in each category of credit rating in a rating scale (e.g., AAA, AA, A, BBB, BB, B, CCC, CC, and C) that over a given time period were downgraded or upgraded to another credit rating category ("transition rates") and went into default ("default rates"). The goal is to provide a mechanism for users of credit ratings to compare the statistical performance of credit ratings across NRSROs.

120 See 17 CFR 240.17g-2(d). This type of disclosure shows the credit rating history of a given rated obligor, security, or money market instrument. Specifically, it shows the initial credit rating and all subsequent modifications to the credit rating (such as upgrades, downgrades, and placements on watch) and the dates of such actions. The goal is to allow users of credit ratings to compare how different NRSROs rated an individual

rulemaking mandated in Section 15E(q) of the Exchange Act, in substantial part, by significantly enhancing the requirements for generating and disclosing this information by amending the instructions to Form NRSRO as they relate to Exhibit 1 and amending Rule 17g-1, Rule 17g-2, and Rule 17g-7.[121]

### 1. Proposed Enhancements to Disclosures of Performance Statistics

The Commission proposes to implement the rulemaking mandated in Section 15E(q) of the Exchange Act, in part, by amending Instruction H to Form NRSRO (the "instructions for Exhibit 1") and Rule 17g-1.[122]

#### a. Proposed Amendments to Instructions for Exhibit 1

Exhibit 1 is part of the registration application a credit rating agency seeking to be registered as an NRSRO (an "applicant") must submit to the Commission and an NRSRO must file with the Commission, keep up-to-date, and publicly disclose.[123] Section 15E(a)(1)(B)(i) of

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obligor, security, or money market instrument and how and when those ratings were changed over time. The disclosure of ratings histories also is designed to provide "raw data" that can be used by third parties to generate independent performance statistics such as transition and default rates.

121 See proposed amendments to Instruction H to Form NRSRO (as it relates to Exhibit 1), paragraph (i) of Rule 17g-1, paragraph (d) of Rule 17g-2, and proposed new paragraph (b) of Rule 17g-7.

122 See proposed amendments to the instructions for Exhibit 1 and paragraph (i) of Rule 17g-1.

123 In particular, Section 15E(a)(1)(A) of the Exchange Act requires an applicant to furnish an application for registration to the Commission, in such form as the Commission shall require, by rule or regulation. See 15 U.S.C. 78o-7(a)(1)(A). Section 15E(a)(1)(B) of the Exchange Act identifies information that must be included in the application for registration. See 15 U.S.C. 78o-7(a)(1)(B)(i)-(x). The Commission implemented Sections 15E(a)(1)(A) and (B) of the Exchange Act by adopting Form NRSRO. See Form NRSRO; see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33569-33582 (June 18, 2007). Section 15E(a)(3) of the Exchange Act provides that the Commission, by rule, shall require an NRSRO, upon being granted registration, to make the information and documents in its completed application for registration, or in any amendment to its

the Exchange Act requires that the registration application include performance measurement statistics over short-term, mid-term, and long-term periods (as applicable).[124] The Commission implemented this requirement, in large part, through Exhibit 1 to Form NRSRO and the instructions for Exhibit 1.[125] Section 15E(b)(1)(A) of the Exchange Act provides that the performance measurement statistics must be updated annually in an annual submission of the registration application required by Section 15E(b)(2) (the "annual certification").[126]

The instructions for Exhibit 1 require an applicant and NRSRO to provide performance measurement statistics of the credit ratings of the applicant or NRSRO, including performance measurement statistics of the credit ratings separately for each class of credit rating for which the

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application, publicly available on its website, or through another comparable, readily accessible means, except for certain information that is submitted on a confidential basis. See 15 U.S.C. 78o-7(a)(3). The Commission implemented this provision by adopting paragraph (i) of Rule 17g-1. See 17 CFR 240.17g-1(i); see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33569 (June 18, 2007). Section 15E(b)(1) requires an NRSRO to promptly amend its application for registration if any information or document provided therein becomes materially inaccurate; however, (as discussed below) certain information does not have to be updated and other information must be updated only on an annual basis. See 15 U.S.C. 78o-7(b)(1); see also 15 U.S.C. 78o-7(b)(1) and 15 U.S.C. 78o-7(a)(1)(B)(ix). The Commission implemented this provision by adopting Form NRSRO and paragraph (e) of Rule 17g-1. See Form NRSRO and 17 CFR 240.17g-1(e); see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33567, 33569-33582 (June 18, 2007).

124 See 15 U.S.C. 78o-7(a)(1)(B)(i).

125 See instructions for Exhibit 1.

126 See 15 U.S.C. 78o-7(b)(1) and (2). In particular, Section 15E(b)(2) of the Exchange Act provides that not later than 90 days after the end of each calendar year, an NRSRO shall file with the Commission an amendment to its registration application, in such form as the Commission, by rule, may prescribe: (1) certifying that the information and documents in the application for registration continue to be accurate; and (2) listing any material change that occurred to such information and documents during the previous calendar year. See 15 U.S.C. 78o-7(b)(2). The Commission implemented these provisions by adopting Form NRSRO and paragraph (f) of Rule 17g-1. See Form NRSRO and 17 CFR 240.17g-1(f); see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33567, 33569-33582 (June 18, 2007).

applicant is seeking registration or the NRSRO is registered.[127] The classes of credit ratings for which an NRSRO can be registered are enumerated in the definition of "nationally recognized statistical rating organization" in Section 3(a)(62) of the Exchange Act: (1) financial institutions, brokers, or dealers;[128] (2) insurance companies;[129] (3) corporate issuers;[130] (4) 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");[131] and (5) issuers of government securities, municipal securities, or securities issued by a foreign government.[132] With respect to the fifth class of credit ratings, the instructions for Exhibit 1 require the NRSRO to provide performance measurement statistics for the following three subclasses (as opposed to

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127 See instructions for Exhibit 1.

128 See 15 U.S.C. 78c(a)(62)(A)(i).

129 See 15 U.S.C. 78c(a)(62)(A)(ii).

130 See 15 U.S.C. 78c(a)(62)(A)(iii).

131 See 15 U.S.C. 78c(a)(62)(A)(iv). The instructions for Exhibit 1 broaden this class of credit rating to include a credit rating of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. The intent of the instruction is to include in the class (and, therefore, in the performance statistics for the class) credit ratings for structured finance products that are outside the scope of the definition referenced in Section 3(a)(62)(A)(iv) of the Exchange Act. See 15 U.S.C. 78c(a)(62)(A)(iv) and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6458 (Feb. 9, 2009). As discussed below, the Commission is proposing to continue to use a broadened definition in the proposed new instructions for Exhibit 1. Moreover, the term "structured finance product" as used throughout this release refers broadly to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63832, footnote 3 (Dec. 4, 2009). This broad category of financial instrument includes an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)) and other types of structured debt instruments such as collateralized debt obligations CDOs, including synthetic and hybrid CDOs. Id. The term "Exchange Act-ABS" as used throughout this release refers more narrowly to an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act. 15 U.S.C. 78c(a)(77).

132 See 15 U.S.C. 78c(a)(62)(A)(v).

the class as a whole): sovereigns, United States public finance, and international public finance.[133]

In addition, the instructions require that the performance measurement statistics "must at a minimum show the performance of credit ratings in each class over 1-year, 3-year, and 10-year periods (as applicable) through the most recent calendar year-end, including, as applicable: historical ratings transition and default rates within each of the credit rating categories,[134] notches, grades, or rankings used by the Applicant/NRSRO as an indicator of the assessment of the creditworthiness of an obligor, security, or money market instrument in each class of credit rating."[135] Paragraph (i) of Rule 17g-1 provides, among other things, that the NRSRO must make the annual certification publicly available within 10 business days of furnishing the annual certification to the Commission.[136]

Currently, the instructions for Exhibit 1 do not prescribe the methodology an NRSRO must use to calculate and present the performance measurement statistics; nor do the instructions limit the type of information that can be disclosed in the Exhibit.[137] Consequently, NRSROs

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133 See instructions for Exhibit 1.

134 The transition rate is the percentage of ratings at a given rating notch that transition to another specified rating notch over a given time period. Only ratings that were outstanding at the beginning of the time period are used in the calculation of the transition rate. Transition rates are generally used to measure the stability of the ratings. The default rate is the percentage of ratings at a given rating notch that have defaulted over a given time period. Only the ratings that were outstanding at the beginning of the time period are used in the calculation.

135 See instructions for Exhibit 1.

136 See 17 CFR.240.17g-1(i).

137 When adopting Form NRSRO, the Commission explained that the instructions would not prescribe how NRSROs must calculate transition rates and default rates, noting that commenters had opposed a standard approach because NRSROs use different methodologies to determine credit ratings. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33574 (June 18, 2007). The Commission stated that it intended to continue to consider the issue

have used different techniques to produce performance measurement statistics, which has limited the ability of investors and other users of credit ratings to compare the performance of credit ratings across NRSROs.[138] In addition, several NRSROs have included substantial amounts of information in Exhibit 1 about performance measurement statistics, in addition to transition and default rates. These practices make the presentation of information in the Exhibits widely inconsistent across NRSROs.

For the foregoing reasons and to implement Section 15E(q) of the Exchange Act, the Commission is proposing significant enhancements to the requirements to disclose performance measurement statistics in Exhibit 1.[139] The enhancements would confine the disclosures in the Exhibit to transition and default rates and certain limited supplemental information. Moreover, the enhancements would standardize the production and presentation of the transition and default rates.[140] Specifically, the Commission preliminarily believes that the transition and default rates in Exhibit 1 should be produced using a "single cohort approach."[141] As explained below, under this approach, an applicant and NRSRO, on an annual basis, would be required to compute how

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"to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of performance between NRSROs." Id. The Commission incrementally standardized the disclosure requirements in Exhibit 1 by amending the Form in 2009 to require an NRSRO to disclose transition and default rates for each class of credit rating for which it was registered and for 1-, 3-, and 10-year periods. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations 74 FR at 6457-6459 (Feb. 9, 2009).

138 See, e.g., Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance Related Disclosures, GAO Report 10-782 (Sept. 2010) ("GAO Report 10-782").

139 See 15 U.S.C. 78o-7(q) and proposed amendments to instructions for Exhibit 1.

140 See 15 U.S.C. 78o-7(q)(2)(B).

141 See GAO Report 10-782, pp. 27-37 (comparing, among other things, a single cohort approach – the model for the Commission's proposal – with an average cohort approach). See also GAO Report 10-782, p. 25, note 38 (identifying more complex techniques for calculating credit rating performance measurement statistics).

the credit ratings assigned to obligors, securities, and money market instruments in a particular class or subclass of credit rating that were outstanding on the date 1, 3, and 10 years prior to the most recent calendar year-end performed during the respective 1-, 3-, and 10-year time period. The Commission's intent in proposing these enhancements is to make the Exhibit 1 disclosures simply presented, easy to understand, uniform in appearance, and comparable across NRSROs.[142]

To implement this proposal, the Commission is proposing to substantially revise the instructions for Exhibit 1.[143] The proposed new instructions would be divided into paragraphs (1), (2), (3), and (4), some of which would have subparagraphs.[144] The proposed new paragraphs would contain specific instructions with respect to, among other things, how required information must be presented in the Exhibit (including the order of presentation) and how transition and default rates must be produced using a single cohort approach. As with all information that must be submitted in Form NRSRO and its Exhibits, applicants and NRSROs would be subject to these requirements.[145]

Proposed Paragraph (1) of the Instructions for Exhibit 1. Proposed new paragraph (1) of the instructions for Exhibit 1 would require an applicant and NRSRO to provide performance

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142 See Section 15E(q)(2)(A) of the Exchange Act, which provides that the disclosure of information about the performance of credit ratings should be comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs. 15 U.S.C. 78o-7(q)(2)(A). See also Section 15E(q)(2)(B) of the Exchange Act, which provides that the disclosure of information about the performance of credit ratings should be clear and informative for investors having a wide range of sophistication who use or might use credit ratings. 15 U.S.C. 78o-7(q)(2)(B).

143 See proposed amendments to instructions for Exhibit 1.

144 See proposed new paragraphs (1), (2), (3), and (4) of the instructions for Exhibit 1.

145 Form NRSRO must be used by a credit rating agency to apply for registration as an NRSRO and, once registered, an NRSRO must publicly disclose the information required in Form NRSRO and Exhibits 1 though 9. See 17 CFR 240.17g-1 and Instructions A.1, B, C, D, E, and F to Form NRSRO.

measurement statistics for each class and subclass of credit ratings for which the applicant is seeking registration as an NRSRO or the NRSRO is registered.[146] Consistent with the current instructions, proposed new paragraph (1) would require an applicant and NRSRO to provide transition and default rates for 1-, 3-, and 10-year periods for each applicable class or subclass of credit rating.[147] Also consistent with the current instructions, proposed new paragraph (1) would require an applicant and NRSRO to produce and present three separate transition and default statistics for each applicable class or subclass of credit rating; namely, for 1-, 3-, and-10 year time periods through the most recently ended calendar year. In addition, as part of the enhancements, an applicant and NRSRO would need to present the transition and default rates for each time period together in tabular form using a standard format (a "Transition/Default Matrix").[148]

Proposed new paragraph (1) would identify the classes and subclasses of credit ratings for which an applicant and NRSRO would need to produce Transition/Default Matrices, as applicable. The identified classes would reference the classes of credit ratings for which an NRSRO can be registered as enumerated in the definition of NRSRO in Section 3(a)(62)(A) of the Exchange Act.[149] This would be consistent with the current instructions for Exhibit 1.[150] Moreover, also consistent with the current instructions, the class of credit ratings enumerated in Section 3(a)(62)(A)(iv) of the Exchange Act (issuers of certain asset-backed securities) would be

146 See proposed new paragraph (1) of the instructions for Exhibit 1.

147 Compare current instructions for Exhibit 1 with proposed new paragraph (1) of the instructions for Exhibit 1.

148 See proposed new paragraph (1) of the instructions for Exhibit 1.

149 Compare 15 U.S.C. 78c(a)(62)(A)(i)-(v) with proposed new paragraphs (1)(A)-(E) of the instructions for Exhibit 1.

150 Compare current instructions for Exhibit 1 with proposed new paragraph (1).

expanded by the instructions in proposed new paragraph (1) to include a broader range of structured finance products than are within the scope of the definition of Section 3(a)(62)(A)(iv).[151]

However, to enhance the disclosure of transition and default rates in this class, the Commission is proposing to divide it into the following subclasses: RMBS;[152] commercial mortgage backed securities ("CMBS");[153] collateralized loan obligations ("CLOs");[154] CDOs;[155] issuances of asset-backed commercial paper conduits ("ABCP");[156] other asset-backed securities;[157] and other structured finance products.[158] The Commission preliminarily believes

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151 See 15 U.S.C. 78c(a)(62)(A)(iv); compare current Instructions for Exhibit 1 with proposed new paragraph (1)(D).

152 The Commission preliminarily intends that an "RMBS" for the purposes of this disclosure requirement would mean a securitization of primarily residential mortgages. See proposed new paragraph (1)(D)(i) of the instructions for Exhibit 1.

153 The Commission preliminarily intends that a "CMBS" for the purposes of this disclosure requirement would mean a securitization of primarily commercial mortgages. See proposed new paragraph (1)(D)(ii) of the instructions for Exhibit 1.

154 The Commission preliminarily intends that a "CLO" for the purposes of this disclosure requirement would mean a securitization of primarily commercial loans. See proposed new paragraph (1)(D)(iii) of the Instructions for Exhibit 1.

155 The Commission preliminary intends that a "CDO" for the purposes of this disclosure requirement would mean a securitization primarily of other debt instruments such as RMBS, CMBS, CLOs, CDOs, other asset-backed securities, and corporate bonds. See proposed new paragraph (1)(D)(iv) of the instructions for Exhibit 1.

156 The Commission preliminarily intends that "ABCP" for the purposes of this disclosure requirement would mean short term notes issued by a structure that securitizes a variety of financial assets (e.g., trade receivables, credit card receivables), which secure the notes. See proposed new paragraph (1)(D)(v) of the instructions for Exhibit 1.

157 The Commission preliminarily intends that the term "other asset-backed security" for the purposes of this disclosure requirement would mean a securitization primarily of auto loans, auto leases, floor plan financings, credit card receivables, student loans, consumer loans, equipment loans, or equipment leases. See proposed new paragraph (1)(D)(vi) of the instructions for Exhibit 1.

158 The Commission preliminarily intends that "other structured finance product" for the purposes of this disclosure requirement would mean a structured finance product that

dividing the broad class of structured finance products into these subclasses would provide investors and other users of credit ratings with more useful information about the performance of an NRSRO's structured finance ratings.[159] For example, during the recent crisis, NRSROs assigned credit ratings to RMBS and CDOs that performed far differently than credit ratings of some other types of securitizations.[160] Consequently, if an applicant or NRSRO computed transition and default rates for structured finance products as a single class, the underperformance of certain subclasses could be muted by the better performance of other subclasses.

Consistent with the current instructions, proposed new paragraph (1) would divide the class of credit ratings enumerated in Section 3(a)(62)(A)(v) of the Exchange Act (issuers of government securities, municipal securities or securities issued by a foreign government) into three subclasses.[161] The subclasses would continue to be: sovereign issuers; United States public finance; and international public finance.[162]

In addition, consistent with the current instructions for an annual certification, proposed new paragraph (1) would provide that the performance measurement statistics must be updated

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does not fit into any of the other subclasses of structured products. See proposed new paragraph (1)(D)(vii) of the instructions for Exhibit 1.

159 See, e.g., GAO Report 10-782, p. 36 (noting that NRSROs active in rating structured finance generally present performance statistics for this class by sectors (e.g., RMBS, CMBS and ABS) in their voluntary disclosures). See also, GAO Report 10-782, p. 36 (observing that the various structured finance sectors have risk characteristics that vary significantly and, therefore, that presenting performance statistics for the class as a whole "may not be useful.").

160 See, e.g., A Global Cross-Asset Report Card of Ratings Performance in Times of Stress, Standard & Poor's (June 8, 2010).

161 See 15 U.S.C. 78c(a)(62)(A)(v); compare current instructions for Exhibit 1, with proposed new paragraph (1)(E).

162 See proposed new paragraph (1)(E) of the instructions for Exhibit 1.

yearly in the NRSRO's annual certification in accordance with Section 15E(b)(1)(A) and paragraph (f) of Rule 17g-1 (i.e., a Form NRSRO with updated performance measurement statistics must be filed with the Commission no later than 90 days after the end of the calendar year).[163] Proposed new paragraph (1) also would remind an NRSRO that, pursuant to paragraph (i) of Rule 17g-1, the annual certification with the updated performance measurement statistics must be made publicly and freely available on an easily accessible portion of the NRSRO's corporate Internet website within 10 business days after the filing and that the NRSRO must make its up-to-date Exhibit 1 freely available in writing to any individual who requests a copy of the Exhibit.[164]

Proposed Paragraph (2) of the Instructions for Exhibit 1. Proposed new paragraph (2) of the instructions for Exhibit 1 would prescribe how an applicant and NRSRO must present the performance measurement statistics and other required information in the Exhibit.[165] Specifically, it would require that the Transition/Default Matrices for each applicable class and subclass of credit ratings be presented in the order that the classes and subclasses are identified in

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163 See Instruction F to Form NRSRO and proposed new paragraph (1); see also 15 U.S.C. 78o-7(b)(1)(A) and 17 CFR 240.17g-1(f). While paragraph (f) of Rule 17g-1 currently requires the annual certification to be "furnished," the Commission is proposing, as discussed below in Section II.M.1 of the release, to replace the term "furnished" with the term "filed" in a number of the NRSRO rules, including Rule 17g-1.

164 See proposed new paragraph (1) of the instructions for Exhibit 1. As discussed below in Section II.E.1.b of this release, the Commission is proposing to amend paragraph (i) of Rule 17g-1 (17 CFR 240.17g-1(i)) to implement Section 15E(q)(2)(D) of the Exchange Act, which provides that the Commission's rules must require that the information about the performance of credit ratings be published and made freely available on an easily accessible portion of an NRSRO's website, and in writing when requested. See 15 U.S.C. 78o-7(q)(2)(D). As discussed below, the proposed amendment to paragraph (i) of Rule 17g-1 (17 CFR 240.17g-1(i)) would require an NRSRO to publish and make freely available on an easily accessible portion of its website all of Form NRSRO (i.e., not just Exhibit 1). However, only Exhibit 1 would need to be made freely available in writing when requested.

165 See proposed new paragraph (2) of the instructions for Exhibit 1.

proposed paragraphs (1)(A) through (E) of Exhibit 1. In addition, the order of the Transition/Default Matrices for a given class or subclass would need to be: the 1-year matrix, the 3-year matrix, and then the 10-year matrix. Proposed new paragraph (2) also would provide that if the applicant or NRSRO did not issue credit ratings in a particular class or subclass for the length of time necessary to produce a Transition/Default Matrix for a 1-, 3-, or 10-year period, it would need to explain that fact in the location where the Transition/Default Matrix would have been presented in the Exhibit.[166]

Similar to the current Instructions, proposed paragraph (2) would require an applicant and NRSRO to clearly define in Exhibit 1, after the presentation of all applicable Transition/Default Matrices, each symbol, number, or score in the rating scale used by the applicant or NRSRO to denote a credit rating category and notches within a category for each class and subclass of credit ratings in any Transition/Default Matrix presented in the Exhibit.[167] The instructions also would require the applicant or NRSRO to clearly explain the conditions under which it classifies obligors, securities, or money market instruments as being in default. As discussed below, the Commission preliminarily believes that obligors, securities, and money market instruments that the applicant or NRSRO has classified as being in default as of the period start date for a

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166 For example, if an NRSRO is registered in the corporate issuer class but has been issuing credit ratings for only 7 years in that class, it could not produce a 10-year Transition/Default Matrix for the class. Instead, the NRSRO would need to provide an explanation in the location where a 10-year Transition/Default Matrix would have been located (i.e., after the 3-year matrix) that it had not been issuing credit ratings in that class for a sufficient amount of time to produce a 10-year Transition/Default Matrix.

167 Compare current instructions for Exhibit 1, with proposed new paragraph (2). As discussed in Section II.J.2 of this release, the Commission is proposing to implement Section 938(a)(2) of the Dodd-Frank Act through paragraph (b)(2) of new Rule 17g-8, which would require an NRSRO to have policies and procedures reasonably designed to clearly define the meaning of any symbol used by the NRSRO to denote a credit rating, including in Exhibit 1 to Form NRSRO. See Pub. L. No. 111-203 § 938(a)(2) and proposed paragraph (b)(2) of new Rule 17g-8.

Transition/Default Matrix should be excluded from the statistics in the matrix. Also, as discussed below, the Commission is proposing a standard definition of "default" for the purpose of calculating default rates. In addition, also as discussed below, where an applicant or NRSRO has a definition of "default" that is broader than this standard definition, the instructions would require the applicant or NRSRO to supplement the standard definition with its internal definition. For these reasons, the Commission believes it would be useful for investors and other users of credit ratings to know how an NRSRO defines default.

Similar to the current instructions, proposed paragraph (2) would require that an applicant and NRSRO provide in Exhibit 1 the uniform resource locator (URL) of its corporate Internet website where the credit rating histories required to be disclosed pursuant to paragraph (b) of Rule 17g-7 would be located (in the case of an applicant) or are located (in the case of an NRSRO).[168]

Finally, proposed paragraph (2) would provide that Exhibit 1 must contain no performance measurement statistics or information other than as described in, and required by, the instructions for Exhibit 1; except the applicant or NRSRO would be permitted to provide, after the presentation of all required Transition/Default Matrices and other required disclosures, Internet website URLs where other information relating to performance measurement statistics of the applicant or NRSRO is located.[169] As noted above, some NRSROs include substantial

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[168] Compare current instructions for Exhibit 1, with proposed new paragraph (2). As discussed below in Section II.E.2 of this release, the Commission is proposing to amend Rule 17g-2 (17 CFR 240.17g-2) and Rule 17g-7 (17 CFR 240.17g-7) to enhance the credit rating history disclosure requirements currently located in Rule 17g-2. Among other things, the Commission proposes relocating the credit rating history disclosure requirements from Rule 17g-2 to proposed new paragraph (b) of Rule 17g-7. See proposed amendments to paragraph (d) of Rule 17g-2 and proposed new paragraph (b) of Rule 17g-7.

[169] See proposed new paragraph (2) of the instructions for Exhibit 1.

amounts of information in Exhibit 1 about the performance of their credit ratings. The Commission preliminarily believes information in addition to the disclosures that would be required under the enhancements to Exhibit 1 may be useful to investors and other users of credit ratings. However, the Commission also preliminarily believes disclosing this related information in Exhibit 1 would make the Exhibit less easy to use in terms of locating a particular Transition/Default Matrix and comparing it with the matrices of other NRSROs. Consequently, the Commission preliminarily believes an appropriate balance would be to exclude related information from the Exhibit but permit an NRSRO to cross-reference such information by providing Internet website URLs at the end of the Exhibit.

Proposed Paragraph (3) of the Instructions for Exhibit 1. Proposed paragraph (3) of the Instructions for Exhibit 1 would prescribe how an applicant and NRSRO must design a Transition/Default Matrix.[170] The instructions would require an applicant and NRSRO to produce a 1-, 3-, and 10-year Transition/Default Matrix for each applicable class and subclass of credit rating that resembles, in design, the Transition/Default Matrix in Figure 1 below.[171]

**Figure 1**
**Corporate Issuers – 10-Year Transition and Default Rates**
(December 31, 2000 through December 31, 2010)

170 See proposed new paragraph (3) of the instructions for Exhibit 1.

171 However, as explained below, the top row and first column would be based on the rating scale used by the applicant or NRSRO for the applicable class or subclass of credit ratings. For example, in the Sample Transition/Default Matrix, there are nine categories denoted by the symbols: AAA, AA, A, BBB, BB, B, CCC, CC, and C but no notches within those categories. An NRSRO that uses notches in its ratings scale (e.g., AA+, AA, and AA-) would need to include the symbol for each notch in the individual cells of the first column and top row. However, as discussed below, the applicant or NRSRO would exclude a "default" category even if it uses such a category in its rating scale (though, as explained below, there would be a column with the heading "Default" in the matrix that would depict the percent of rated obligors, securities, and money market instruments that went into default during the relevant time period based on a standard definition of "default" in the instructions for Exhibit 1 (i.e., not on the definition of the applicant or NRSRO).

| Credit Rating Scale | Number Of Ratings Outstanding as of 12/31/2000 | AAA | AA | A | BBB | BB | B | CCC | CC | C | Default | Paid Off | Withdrawn (other) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| AAA | 10 | 50% | 10% | | | | | | | | | 40% | |
| AA | 2000 | 1% | 39% | 12% | 10% | 8% | 5% | 4% | | | 1% | 19% | 1% |
| A | 4000 | | 6% | 34% | 15% | 10% | 6% | 4% | 3% | | 2% | 18% | 2% |
| BBB | 3600 | | 2% | 9% | 28% | 15% | 10% | 6% | 5% | 1% | 4% | 17% | 3% |
| BB | 1000 | | | 2% | 4% | 20% | 14% | 5% | | | 2% | 16% | 37% |
| B | 500 | | | 1% | 3% | 6% | 20% | 20% | 15% | | 15% | 15% | 5% |
| CCC | 300 | | | | | 4% | 6% | 15% | 25% | 20% | 20% | 4% | 6% |
| CC | 200 | | | | | | 2% | 8% | 10% | 38% | 30% | 2% | 10% |
| C | 160 | | | | | | | 2% | 8% | 10% | 67% | 1% | 12% |
| Total | 11,770 | | | | | | | | | | | | |

A sample Transition/Default Matrix similar to Figure 1 would be depicted in proposed new paragraph (3) to provide a visual representation of how to design and present a matrix.[172] In addition to the visual depiction, proposed new paragraph (3) would contain narrative instructions on how to design a matrix. First, the narrative instructions would prescribe the headings for each required column in a Transition/Default Matrix by referring to the cells in the top row of the table (the "header row").[173] The narrative instructions would require that the first and second cells in the header row contain the headings, respectively, "Credit Rating Scale" and "Number of Ratings Outstanding as of [insert the applicable date]."[174] The applicable date would be the date 1, 3, or 10 years prior to the most recent calendar year-end depending on whether the Transition/Default Matrix was being produced for a 1-, 3-, or 10-year period. The next sequence of cells in the header row would need to contain, in order from left to right, each credit rating symbol, number, or score used to denote a category and a notch within a category in the rating scale used by the applicant or NRSRO for the applicable class or subclass of credit

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172 See proposed new paragraph (3) of the instructions for Exhibit 1.

173 See proposed new paragraph (3) of the instructions for Exhibit 1.

174 See, e.g., the 1st and 2nd columns of the Sample Transition/Default Matrix in Figure 1.

ratings in descending order from the highest to the lowest notch.[175] The narrative instructions would require that the applicant or NRSRO not include a "default" category in the header row even if such a category is used in the rating scale.[176] The narrative instructions would require that the cells in the last three columns in the Transition/Default Matrix contain the headings, in order from left to right, "Default", "Paid Off", and "Withdrawn (other)."[177]

Next, the narrative instructions would require that the first column have a separate cell containing each credit rating symbol, number, or score in the rating scale used by the applicant or NRSRO to denote a category and a notch within a category for the applicable class or subclass of credit ratings in descending order from the highest to the lowest notch.[178] The applicant or NRSRO would be required to populate the column with the credit rating symbols, numbers, or scores in descending order from the highest to the lowest notch. Consistent with the header row, the narrative instructions also would require that the first column not include a "default" category if the applicant or NRSRO uses such a category in its rating scale. The last cell in the first column would need to contain the term "Total."[179]

Finally, the narrative instructions would require that the Transition/Default Matrix have a title identifying the applicable class or subclass of credit ratings, the period covered (1, 3, or 10 years), and start date and end date for the period.

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175 See proposed new paragraph (3) of the instructions for Exhibit 1; see also the 3rd through 11th columns of the Sample Transition/Default Matrix in Figure 1.

176 The Commission's reasoning for proposing to exclude a category of "default" from the first column is explained below.

177 See proposed new paragraph (3) of the instructions for Exhibit 1; see also the 12th through 14th columns of the Sample Transition/Default Matrix in Figure 1.

178 See, e.g., the first column of the Sample Transition/Default Matrix in Figure 1.

179 See proposed new paragraph (3) of the instructions for Exhibit 1; see also the first column of the Sample Transition/Default Matrix in Figure 1.

Proposed Paragraph (4) of the Instructions for Exhibit 1. Proposed new paragraph (4) of the instructions for Exhibit 1 would prescribe how an applicant or NRSRO would need to populate a Transition/Default Matrix with data and statistical information.[180] First, proposed new paragraph (4)(A) would prescribe how to populate the cells of the second column headed "Number of Ratings Outstanding [as the Start Date]."[181] First, the applicant or NRSRO would be required to determine a start-date cohort consisting of the obligors, securities, and money market instruments in the applicable class or subclass of credit ratings that were assigned a credit rating (other than an expected or preliminary credit rating)[182] that was outstanding as of the start date for the applicable period (i.e., the date 1, 3, or 10 years prior to the most recently ended calendar year).[183] Consequently, the start-date cohort would exclude any obligor, security, or

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180 See proposed paragraph (4) of the instructions for Exhibit 1.

181 See proposed paragraph (4)(A) of the instructions for Exhibit 1; see also the 2nd column of the Sample Transition/Default Matrix in Figure 1.

182 "Expected" or "preliminary" credit ratings most commonly are issued by an NRSRO with respect to a structured finance product at the time the issuer commences the offering and typically are included in pre-sale reports. Expected or preliminary credit ratings may include a range of ratings, or any other indications of a credit rating used prior to the assignment of an initial credit rating for a new issuance. As such, the Commission preliminarily believes they should be excluded from the Transition/Default Matrices since the issuance of the "initial" credit rating is the first formal expression of the NRSRO's view of the relative creditworthiness of the obligor, security, or money market instrument.

183 For example, if the most recent year end was December 31, 2010, the NRSRO would need to determine all the obligors, securities, and money market instruments with credit ratings outstanding in the relevant class as of December 31, 2009 (for the 1-year Transition/Default Matrix), December 31, 2007 (for the 3-year Transition/Default Matrix), and December 31, 2000 (for the 10-year Transition/Default Matrix). Because some obligors, securities, and money market instruments have characteristics that could cause them to be assigned more than one class of credit rating, the Commission is seeking comment below in Section II.M.4.a of this release on which class would be the most appropriate for certain types of obligors, securities, and money market instruments. Based on the comments received in response to those questions, the Commission may decide to prescribe by rule or identify through guidance how certain types of obligors, securities,

money market instrument that received an initial credit rating in the class or subclass after the start date.[184]

In addition, the proposed instructions would provide that the applicant or NRSRO must exclude from the start-date cohort any obligors, securities, or money market instruments that were classified by the applicant or NRSRO as being in default as of the period start date.[185] The Commission preliminarily believes that the Transition/Default Matrices should not include obligors, securities, and money market instruments the applicant or NRSRO has classified as in default.[186] The reason is that, if an applicant or NRSRO classifies an obligor, security, or money

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and money market instruments should be classified for the purpose of determining start-date cohorts.

184 For example, a Transition/Default Matrix covering a 10-year period would not include obligors, securities, and money market instruments that had been rated by the NRSRO for less than 10 years. However, these obligors, securities, and money instruments may be included in the start-date cohorts for the 1- and 3-year matrices for the class or subclass.

185 See proposed paragraph (4)(A) of the instructions for Exhibit 1. As indicated, the determination of whether an obligor, security, or money market instrument should be excluded from the start date cohort would be based on the definition of "default" used by the applicant or NRSRO. As discussed below, in determining the outcome of a credit rating assigned to an obligor, security, and money market instrument during the applicable time period covered by a Transition/Default Matrix, the applicant or NRSRO would need to use a standard definition of "default" in proposed new paragraph (4)(B)(iii) as opposed to its own definition. The Commission recognizes that the use of a standard definition of "default" to determine the outcome of a credit rating during the applicable time period could result in an obligor, security, or money market instrument being included in the start-date cohort that, as of the start date, would be classified as in "default" under the proposed definition of "default" in paragraph (4)(B)(iii). In other words, the applicant or NRSRO may not have classified the obligor, security, or money market instrument as in default as of the start date using its own narrower definition. In this case, the Commission preliminarily believes such an obligor, security, or money market instrument should be included in the start-date cohort since the applicant or NRSRO had assigned it a credit rating representing a relative assessment of the likelihood of default (rather than a classification of default) on the start date. Therefore, the performance of the applicant or NRSRO in rating that obligor, security, or money market instrument should be incorporated into the default rate.

186 This does not mean that the obligor, security or money market instrument would never be reflected in default rates. For example, assume that as of the date 10 years prior to the

market instrument as in default, the applicant or NRSRO is no longer assessing the relative likelihood that the obligor, security, or money market will continue to meet its obligations to make timely payments of principal and interest as they come due (i.e., not default on its obligations). Consequently, as long as the obligor, security, or money market instrument continues to be classified as in default there is no credit rating performance to measure. However, if an obligor, security, or money market instrument is upgraded from the default category because, for example, the obligor emerges from a bankruptcy proceeding, the obligor would need to be included in a Transition/Default Matrix that has a start date after the upgrade.[187]

The next step, after determining the start-date cohort, would be to determine the number of obligors, securities, and money market instruments in the start-date cohort that, as of the start

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most recently ended calendar year-end an obligor in the corporate issuer class was assigned a credit rating of BBB. This obligor would be included in the start-date cohort for the 10-year Transition/Default Matrix and grouped with the other obligors, securities, and/or money market instruments assigned BBB ratings. Further, assume that during the first seven years of the 10-year period, the credit rating of the obligor was downgraded from BBB to BB (in year 2), from BB to B (in year 5) and from B to CCC (in year 7). Having an outstanding credit rating of CCC in year 7, the obligor would be included in the start-date cohort for the 3-year Transition/Default Matrix and grouped with obligors, securities, and money market instruments assigned CCC ratings. Finally assume the obligor defaults in year 8. For the purposes of the 10- and 3-year Transition/Default Matrices, the obligor would need to be classified as having defaulted and included in the default rates calculated for those matrices. However, because the obligor would be in default as of the period start date for the 1-year Transition/Default Matrix, it would not be included in the start-date cohort for that matrix.

187 See proposed paragraph (4)(A) of the instructions for Exhibit 1. For example, assume an obligor was classified as in default by the NRSRO as of the start date for the 10-year Transition/Default Matrix. The obligor would be excluded from the start-date cohort for the matrix. Assume further that two years later the obligor emerged from a bankruptcy proceeding after a re-structuring. At that point in time, the NRSRO upgraded the obligor from the default category by assigning it a credit rating of BBB. Assume that three years later the NRSRO upgraded the obligor's credit rating from BBB to A- and that it retained that rating for the next five years. In this case, the obligor would be included in the start-date cohorts for the 1- and 3-year Transition/Default Matrices and grouped with the obligors, securities, and money market instruments assigned A- credit ratings.

date, were assigned a credit rating at each notch in the rating scale used for the class or subclass.[188] The final step would be to populate the appropriate column cells with these amounts and in the bottom cell provide the total number of obligors, securities, and money market instruments in the start-date cohort. As discussed next, determining these totals would be necessary to compute the percentages used to populate the rows of the Transition/Default Matrix. Moreover, the Commission preliminarily believes it would be useful to investors and other users of credit ratings to include these amounts in the matrix. This would inform them of the sample sizes of the obligors, securities, and money market instruments used to generate the transition and default rates for the notches entered in the matrix.[189]

Proposed new paragraph (4)(B) would focus on the horizontal axis of the Transition/Default Matrix by prescribing how an applicant and NRSRO would need to populate the rows representing sequentially in descending order the notches in the credit rating scale used for the applicable class or subclass of credit ratings.[190] The instructions would provide that each

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188 See proposed paragraph (4)(A) of the instructions for Exhibit 1. For the class of credit ratings in the Sample Transition/Default Matrix in Figure 1, this would mean determining how many of the obligors, securities, and money market instruments in the start-date cohort were assigned a credit rating of AAA, AA, A, BBB, BB, B, CCC, CC, and C as of the start date. For example, the Sample Transition/Default Matrix in Figure 1 shows a total start-date cohort of 11,770 obligors, securities, and/or money market instruments. Within this cohort and as of the 12/31/2000 start date, 10 were rated AAA, 2000 were rated AA, 4000 were rated A, 3600 were rated BBB, 1000 were rated BB, 500 were rated B, 300 were rated CCC, 200 were rated CC, and 16 were rated C.

189 For example, if the outcome for a notch with 10 obligors is that 5 defaulted, the default rate reflected on the Transition/Default Matrix for that notch would be 50%. Similarly, if the outcome of a notch with 5,000 obligors is that 2,500 defaulted, the default rate for that notch would be 50% as well. Investors and other users of credit ratings might conclude that 2,500 obligors going into default reflects significantly worse performance than 5 obligors. Consequently, if the sample sizes were not reflected on the matrix, investors and other users of credit ratings could draw conclusions about the comparative performance of NRSROs that are distorted by varying sample sizes.

190 See proposed new paragraph (4)(B) of the instructions for Exhibit 1; see also the 2nd through the 10th rows of the Sample Transition/Default Matrix in Figure 1 (AAA through

row must contain percents indicating the cumulative credit rating outcomes of the obligors, securities, and money market instruments assigned a credit rating at that notch.[191] The instructions also would provide that the percents in a row must add up to 100%.[192]

As discussed in detail below, proposed new paragraph (4)(B) would identify five potential credit rating outcomes: (1) the obligor, security, or money market instrument was assigned the same credit rating as of the period end date; (2) the obligor, security, or money market instrument was assigned a different credit rating as of the period end date; (3) the obligor, security, or money market instrument defaulted at any time during the period; (4) the obligor, security, or money market instrument paid off during the period; or (5) the applicant or NRSRO withdrew a credit rating of the obligor, security, or money market instrument at any time during the period for a reason other than that the obligor, security, or money market instrument defaulted or "paid off."[193] Because the percents in a row would need to add up to 100%, each obligor, security, and money market instrument reflected in the numbers contained in the 2nd

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C).

191 For example, in the Sample Transition/Default Matrix in Figure 1, cumulative outcomes would need to determined for: the 10 obligors, securities, and/or money market instruments in the 2nd row (AAA); the 2000 obligors, securities, and/or money market instruments in the 3rd row (AA); the 4000 obligors, securities, and/or money market instruments in the 4th row (A); the 3600 obligors, securities, and/or money market instruments in the 5th row (BBB); the 1000 obligors, securities, and/or money market instruments in the 6th row (BB); the 300 obligors, securities, and/or money market instruments in the 8th row (CCC); the 200 obligors, securities, and/or money market instruments in the 9th row (CC); and the 160 obligors, securities, and/or money market instruments in the 10th row (C).

192 See proposed new paragraph (4)(B) of the instructions for Exhibit 1. For example, in the Sample Transition/Default Matrix in Figure 1, the percents in the row representing the AAA category are (from left to right): 50%, 10%, and 40%, which when added together equal 100%.

193 See proposed new paragraphs (4)(B)(i)-(v) of the Instructions for Exhibit 1.

column of a Transition/Default Matrix could be assigned only one credit rating outcome.[194] Proposed paragraphs (4)(B)(i) through (v) would instruct applicants and NRSROs how to compute the percents used to populate each row representing a notch in the rating scale in the Transition/Default Matrix.[195]

Proposed new paragraph (4)(B)(i) would require the applicant or NRSRO to determine the number of obligors, securities, and money market instruments assigned a credit rating at the notch represented by the row as of the period start date that were assigned a credit rating at the same notch as of the period end date.[196] The instructions would require that: (1) this number be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date; and (2) the percent be entered in the column representing the same notch.[197]

An obligor, security, or money market instrument could have the same credit rating as of the period end-date because the credit rating did not change between the start date and the end date or the credit rating transitioned to one or more other notches during the relevant period but transitioned back to the start-date notch where it remained as of the period end date. Consequently, proposed new paragraph (4)(B)(i) would clarify that, to determine this amount, the applicant or NRSRO would need to use the credit rating at the notch assigned to the obligor, security, or money market instrument as of the period end date and not a credit rating at any

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194 See proposed new paragraph (4)(B) of the instructions for Exhibit 1; see also the 2nd column in the Sample Transition/Default Table in Figure 1.

195 See proposed new paragraphs (4)(B)(i)-(v) of the instructions for Exhibit 1.

196 See proposed new paragraph (4)(B)(i) of the instructions for Exhibit 1.

197 For example, the 2nd row of the Sample Transition/Default Matrix in Figure 1 represents the AAA notch in the applicable rating scale. As reflected in the matrix, 10 obligors, securities, and/or money market instruments were assigned a credit rating of AAA as of the 12/31/2000 start date. Of these 10, 5 (or 50%) were assigned a credit rating of AAA as of the 12/31/2010 end date. Accordingly, 50% is input in the AAA column.

other notch assigned to the obligor, security, or money market instrument between the period start date and the period end date.[198]

Proposed new paragraph (4)(B)(ii) would require the applicant or NRSRO to determine the number of obligors, securities, and money market instruments assigned a credit rating at the notch represented by the row as of the period start date that were assigned a credit rating at each other notch as of the period end date.[199] The instructions would require that: (1) these numbers be expressed as percents of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date; and (2) the percents be entered in the columns representing each notch.[200] The instructions in the paragraph would clarify that, to determine these numbers, the applicant or NRSRO would need to use the credit rating at the notch assigned to the obligor, security, or money market instrument as of the period

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198 See proposed new paragraph (4)(B)(i) of the instructions for Exhibit 1. For example, assume an obligor was assigned a credit rating of BBB as of the start date of a 10-year Transition/Default Matrix. Assume further that three years after the start date, the credit rating was upgraded to AA but then eight years after the start date the credit rating was downgraded to A, and nine years after the start date the credit rating was downgraded to BBB where it remained as of the period end date. For the purpose of the 10-year Transition/Default Matrix, the outcome assigned this obligor would be that it had the same credit rating as of the period end date. However, the transitions that occurred in years eight and nine would be reflected, respectively, in the 3- and 1-year Transitions/Default Matrices for the class or subclass of credit ratings. In other words, the credit rating history for this obligor would reflect volatility over the short term but stability over the long term.

199 See proposed new paragraph (4)(B)(ii) of the instructions for Exhibit 1.

200 See proposed new paragraph (4)(B)(ii) of the instructions for Exhibit 1. For example, the 3rd row of the Sample Transition/Default Matrix in Figure 1 represents the AA notch in the applicable rating scale. As reflected in the matrix, 2000 obligors, securities, and/or money market instruments were assigned a credit rating of AA as of the 12/31/2000 start date. Of these 2000, as of the period end date: 2 (or 1%) were assigned a credit rating of AAA; 240 (or 12%) were assigned a credit rating of A; 200 (or 10%) were assigned a credit rating of BBB; 160 (or 8%) were assigned a credit rating of BB; 100 (or 5%) were assigned a credit rating of B; and 80 (or 4%) were assigned a credit rating of CCC. Accordingly, 1% is input in the AAA column, 12% in the A column, 10% in the BBB column, 8% in the BB column, 5% in the B column, and 4% in the CCC column.

end-date and not a credit rating at any other notch assigned to the obligor, security, or money market instrument between the period start date and the period end date.[201]

Proposed new paragraph (4)(B)(iii) would require an applicant and NRSRO to determine the total number of obligors, securities, and money market instruments assigned a credit rating at the notch represented by the row as of the period start date that went into Default at any time during the applicable time period.[202] The instructions would require that: (1) this number be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date; and (2) the percent to be entered in the Default column.[203]

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201 See proposed new paragraph (4)(B)(ii) of the instructions for Exhibit 1. This instruction would mirror the instruction in proposed new paragraph (4)(B)(i). As explained above, the applicant or NRSRO would need to reflect in the transition rate for a given notch the credit ratings assigned to the obligors, securities, and money market instruments at that notch as of the period end-date (rather than transitional credit ratings assigned during the period). For example, in the Sample Transition/Default Matrix in Figure 1, there were 2000 obligors, securities and/or money market instruments assigned AA ratings as of 12/31/2000. As of 12/31/2010, 4% (or 80) of the obligors, securities, and/or money market instruments were assigned a credit rating of CCC. The path by which these obligors, securities, or money market instruments arrived at a CCC credit rating as of the period end date could have been through a series of rating actions that occurred during the 10 year period (e.g., being downgraded to A, then BBB, then BB, then B, and then CCC). The transitional credit ratings of these 80 obligors, securities, and money market instruments between the AA credit rating as of 12/31/2000 and the CCC credit rating as of 12/31/2010 would not be reflected in the transition rate for the AA notch.

202 See proposed new paragraph (4)(B)(iii) of the instructions for Exhibit 1. This release denotes the proposed standardized definition of the term "default" as "Default" to distinguish the definition and its meaning from other uses of the term "default" herein.

203 See proposed new paragraph (4)(B)(iii) of the instructions for Exhibit 1. For example, the 7th row of the Sample Transition/Default Matrix in Figure 1 represents the B notch in the applicable rating scale. As reflected in the matrix, 500 obligors, securities, and/or money market instruments were assigned a credit rating of B as of the 12/31/2000 start date. Of these 500, 75 (or 15%) were classified as having gone into Default during period (12/31/2000-12/31/2010). Accordingly, 15% is input in the Default column.

As indicated, the classification of Default would be triggered if the obligor, security, or money market instrument went into Default at any time during the period.[204] This is different than the classifications in proposed paragraphs (4)(B)(i) and (ii), which are based solely on the end-date status of the obligor, security or money market instrument.[205] This period-long approach is designed to address concerns that an applicant or NRSRO might withdraw a credit rating of an obligor, security, or money market instrument that went into Default during the period in order to omit the obligor, security, or money market instrument from the Transition/Default Matrix and, therefore, improve the default rates presented in the matrix.[206]

The Commission preliminarily believes it would be appropriate to prescribe a standard definition of Default in proposed new paragraph (4)(B)(iii).[207] This standard definition would need to be used by all applicants and NRSROs to determine whether an obligor, security, or money market instrument in the start-date cohort defaulted. The Commission's goal in proposing a standard definition is to make the default rates calculated and disclosed by the

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204 See proposed new paragraph (4)(B)(iii) of the instructions for Exhibit 1.

205 See proposed new paragraphs (4)(B)(i) and (ii) of the instructions for Exhibit 1.

206 See 15 U.S.C. 78o-7(q)(2)(C) (providing that the disclosures include performance information over a range of years and for a variety of types of credit ratings, including for credit ratings withdrawn by the NRSRO). The following provides an example of how withdrawals can be used to impact a default rate. In the Sample Transition/Default Matrix in Figure 1, the Default rate over the 10-year period for the 3600 obligors, securities, and money market instruments assigned a BBB rating as of the period start date is 4%. This means that 144 obligors, securities, or money market instruments assigned a credit rating at this notch as of the start date went into Default during the period (144/3600 = 4%). If the default rate was determined by the credit assigned to these 144 obligors as of the period end date, the NRSRO could withdraw, for example, 100 of these credit ratings after default. Consequently, only 44 of the obligors, securities, and/or money market instruments would be in the default category as of the period end-date and, therefore, the default rate for the BBB notch would be 1.2% instead of 4% (44/3600 = 1.2%).

207 See proposed new paragraph (4)(B)(iii) of the Instructions for Exhibit 1.

NRSROs more readily comparable.[208] The Commission is concerned that if applicants or NRSROs use their own definitions of "default," differences in those definitions may result in the applicants and NRSROs inconsistently classifying obligors, securities, and money market instruments as in default.[209] For example, an NRSRO that uses a narrow definition may show better (i.e., lower) default rates than an NRSRO using a broader definition even though the former's credit ratings would perform no better under the broader definition. The Commission preliminarily believes that potential variances in how applicants and NRSROs may define "default" could make comparing performance across NRSROs difficult and could be a way to manipulate the data to produce more favorable results.

The Commission recognizes that a proposal to use a standard definition of default may raise concerns among the NRSROs. For example, in the past, NRSROs have argued against prescribing a standardized approach for calculating transition and default rates given the different meanings of their credit ratings and definitions of default.[210] Nonetheless, as explained above, the Commission preliminarily believes a standard definition is the preferred approach to make disclosures of default rates comparable and, therefore, useful to investors and other users of credit ratings. However, the Commission is requesting comment below on the proposed use of a

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208 See 15 U.S.C. 78o-7(q)(2)(A) (providing that the Commission's rules shall require disclosures that are comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs).

209 See, e.g., GAO Report 10-782, p. 38 ("NRSROs can differ in how they define default. Therefore, some agencies may have higher default rates than others as a result of a broader set of criteria for determining that a default has occurred.").

210 See, e.g., letter dated March 12, 2007 from Jeanne M. Dering, Executive Vice President, Moody's Investors Services and letter dated March 12, 2007 from Vickie A. Tillman, Executive Vice President, Standard & Poor's (commenting on proposals in Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33574 (Feb. 9, 2007).

standard definition, including whether there are alternatives that could achieve the Commission's goal of comparability.

Proposed new paragraph (4)(B)(iii) would prescribe two disjunctive definitions of Default.[211] An applicant and NRSRO would need to classify an obligor, security, or money market instrument as having gone into Default if the conditions in either or both of the definitions were met. The first definition would apply if the obligor failed to timely pay principal or interest due according to the terms of an obligation, or the issuer of the security or money market instrument failed to timely pay principal or interest due according to the terms of the security or money market instrument.[212] This would be the standard definition of Default used by the applicant or NRSRO. The goal of this proposed definition is to establish a minimum baseline for classifying an obligor, security, or money market instrument as having gone into Default. The Commission's intent is to avoid a situation in which applicants and NRSROs use varying definitions of default, which, as noted above, could result in some NRSROs using materially narrower definitions in order to produce more favorable default rates.[213]

The second definition would apply if the applicant or NRSRO classified the obligor, security, or money market instrument as having gone into default using its own definition of "default."[214] This proposal is designed to supplement the standard definition to address a situation where the NRSRO's definition of "default" is broader than the standard definition and,

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211 See proposed new paragraphs (4)(B)(iii)(a) and (b) of the instructions for Exhibit 1.

212 See proposed new paragraphs (4)(B)(iii)(a) of the instructions for Exhibit 1.

213 Because this would be a standard definition, the applicant or NRSRO would need to classify the obligor, security, or money market instrument as having gone into Default even if the applicant or NRSRO assigned a credit rating other than default to the obligor, security, or money market instrument at the time of the event of Default because, for example, the applicant or NRSRO uses a narrower definition of "default."

214 See proposed new paragraph (4)(B)(iii) of the instructions for Exhibit 1.

as a consequence, the NRSRO has classified an obligor, security, or money market instrument as having gone into default during the time period even though, under the standard definition, the applicant or NRSRO would not need to make a Default classification. The Commission preliminarily believes that the standard definition of Default, as proposed, is broad and would apply to most cases commonly understood as a default. Consequently, the Commission preliminarily believes a classification of default under the second definition would be rare.[215]

Finally, proposed new paragraph (4)(B)(iii) also would clarify that an obligor, security, or money market instrument that goes into in Default must be classified as in Default even if the applicant or NRSRO assigned a credit rating to the obligor, security, or money market instrument at a notch above default in its rating scale on or after the event of Default or withdrew the credit rating on or after the event of Default.[216] This proposed clarification is designed to affirm the requirement that an obligor, security, or money market instrument that goes into Default at any time during the period covered by the Transition/Default Matrix must be included in the default

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215 The Commission recognizes that supplementing the standard definition in proposed paragraph (4)(B)(iii) with the definition used by the applicant or NRSRO could potentially import an idiosyncratic element to a given NRSRO's Default classifications. However, any such impact only could increase the number of obligors, securities, and money market instruments classified as having gone into Default (i.e., an internal definition only could expand the standard definition). The Commission is not concerned if an applicant or NRSRO over-classifies (relative to other applicants or NRSROs) the number of obligors, securities, or money market instruments that went into Default, provided all NRSROs are using the standard definition as a baseline. Moreover, the Commission believes any such over-classifications would be de minimis given the broad scope of the standard definition. Furthermore, each obligor, security, and money market instrument in the start-date cohort must be assigned 1 of 5 potential outcomes. Consequently, if an applicant or NRSRO has classified an obligor, security, or money market instrument as having gone into default based on its own definition a classification of Default would be the most appropriate outcome among the 5 possible outcomes identified in proposed new paragraph (4)(B) of the instructions for Exhibit 1.

216 See proposed new paragraph (4)(B)(iii) of the instructions for Exhibit 1.

rate for the applicable category of credit rating irrespective of the post-Default status of the obligor, security, or money market instrument.

Proposed new paragraph (4)(B)(iv) would require an applicant and NRSRO to determine the number of obligors, securities, and money market instruments assigned a credit rating at the notch represented by the row as of the period start date that Paid Off at any time during the applicable time period.[217] The instructions would require that: (1) this amount be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date; and (2) the percent be entered in the Paid Off column.[218] As with the Default classification, this classification would be made if the obligor, security, or money market instrument Paid Off at any time during the period.[219]

Proposed new paragraph (4)(B)(iv) would define Paid Off using two different sets of conditions: (1) one set applicable to obligors; and (2) one set applicable to securities and money market instruments.[220] The reason is that a credit rating of an "obligor" typically means a credit rating of the entity with respect to all obligations of the entity; whereas a credit rating of a "security" or "money market instrument" means a credit rating of a specific debt instrument such as a bond, note, or issuance of commercial paper.[221] Consequently, as used generally, a credit

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217 See proposed new paragraph (4)(B)(iv) of the instructions for Exhibit 1.

218 Id. For example, the 9th row of the Sample Transition/Default Matrix in Figure 1 represents the CC notch in the applicable rating scale. As reflected in the matrix, 200 obligors, securities, and/or money market instruments were assigned a credit rating of CC as of the 12/31/2000 start date. Of these 200, 4 (or 2%) were classified as having Paid Off during period (12/31/2000-12/31/2010). Accordingly, 2% is input in the Paid Off column.

219 See proposed new paragraph (4)(B)(iv) of the instructions for Exhibit 1.

220 See proposed new paragraphs (4)(B)(iv)(a) and (b) of the instructions for Exhibit 1.

221 As discussed earlier, this understanding of the meaning of an "obligor" credit rating is based, in part, on the definition of "credit rating" in Section 3(a)(60) of the Exchange Act ("The term 'credit rating' means an assessment of the creditworthiness of an obligor as an

rating of an obligor does not relate to a single obligation with a term of maturity but rather to the obligor's overall ability to meet any obligations as they come due. Therefore, an obligor credit rating normally would not be classified as Paid Off since it does not reference a specific obligation that will mature. However, the Commission preliminarily believes it is possible that an applicant or NRSRO could determine a credit rating relating directly to an obligor's ability to meet a specific obligation with a definite term to maturity.[222] In this case, the obligor could be classified as having Paid Off given that the obligation to which the credit rating relates is identifiable and was extinguished during the period. At the same time, the Commission's objective is to avoid inadvertently proposing a definition that would permit an NRSRO to classify an obligor assigned a typical obligor credit rating as having Paid Off because it extinguished one of its obligations during the time period.[223]

For these reasons, the Commission proposes that paragraph (4)(B)(iv)(a) provide that an applicant and NRSRO may classify an obligor as having Paid Off only if the applicant or NRSRO assigned the obligor a credit rating with respect to a single specifically identified obligation; the obligor extinguished the obligation during the applicable time period by paying in full all outstanding principal and interest due on the obligation according to the terms of the obligation (e.g., because the obligation matured, was called, or was prepaid); and the applicant or

entity or with respect to specific securities or money market instruments."). See 15 U.S.C. 78o-7(a)(60).

222 For example, an NRSRO could issue a credit rating that relates solely to the likelihood that the obligor would meet an obligation to pay principal and interest on a specific term loan.

223 For example, an applicant or NRSRO could seek to improve its default rates by classifying obligors as having paid off because they extinguished one obligation during the relevant period before defaulting on other obligations.

NRSRO withdrew the credit rating because the obligation was extinguished.[224] The third clause of the proposed definition (that the NRSRO withdrew the credit rating) would be designed to ensure that the credit rating, in fact, did relate to the single specifically identified obligation. If the applicant or NRSRO continued to assign a credit rating to the obligor after the obligation was extinguished, it would suggest that the credit rating related to the obligor's creditworthiness in a broader sense (i.e., not with respect to the single obligation).

As for securities and money market instruments, proposed paragraph (4)(B)(iv)(b) would provide that the applicant or NRSRO may classify a security or money market instrument as having Paid Off only if the issuer of the security or money market instrument extinguished its obligation with respect to the security or money market instrument during the applicable time period by paying in full all outstanding principal and interest due according to the terms of the security or money market instrument (e.g., because the security or money market instrument matured, was called, or was prepaid); and the applicant or NRSRO withdrew the credit rating for the security or money market instrument because the obligation was extinguished.[225] Consequently, the proposed definition would mirror the second and third elements of the definition of Paid Off as it relates to the credit rating of an obligor.[226]

Proposed new paragraph (4)(B)(v) would require the applicant or NRSRO to determine the number of obligors, securities, and money market instruments assigned a credit rating at the notch represented by the row as of the period start date for which the applicant or NRSRO withdrew a credit rating assigned to the obligor, security, or money market instrument at any

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224 See proposed new paragraph (4)(B)(iv)(a) of the instructions for Exhibit 1.

225 See proposed new paragraph (4)(B)(iv)(b) of the instructions for Exhibit 1.

226 Compare proposed new paragraphs (4)(B)(iv)(a) and (b) of the instructions for Exhibit 1.

time during the applicable time period for a reason other than Default or Paid-Off.[227] The instructions would require that: (1) this amount be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date; and (2) the percent be entered in the Withdrawn (other) column.[228] The instructions would provide that the applicant or NRSRO must classify the obligor, security, or money market instrument as Withdrawn (other) even if the applicant or NRSRO assigned a credit rating to the obligor, security, or money market instrument after withdrawing the credit rating.[229]

There are legitimate reasons to withdraw a credit rating assigned to an obligor, security, or money market instrument. For example, an NRSRO might withdraw a credit rating because the rated obligor or issuer of the rated security or money market instrument stopped paying for the surveillance of the credit rating or because the NRSRO issued and was monitoring the credit rating on an unsolicited basis and no longer wanted to devote resources to monitoring it. However, the Commission also is concerned that an applicant or NRSRO could withdraw a credit rating assigned to an obligor, security, or money market instrument to make its transition or default rates appear more favorable.[230] Therefore, the Commission proposes requiring an

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227 See proposed new paragraph (4)(B)(v) of the instructions for Exhibit 1.

228 Id. For example, the 4th row of the Sample Transition/Default Matrix in Figure 1 represents the A notch in the applicable rating scale. As reflected in the matrix, 4000 obligors, securities, and/or money market instruments were assigned a credit rating of A as of the 12/31/2000 start date. Of these 4000, 80 (or 2%) were classified as having been Withdrawn (other) during the period (12/31/2000-12/31/2010). Accordingly, 2% is input in the Withdrawn (other) column.

229 See proposed new paragraph (4)(B)(v) of the instructions for Exhibit 1.

230 For example, the 5th row of the Sample Transition/Default Matrix in Figure 1 represents the BBB notch in the applicable rating scale. 3600 obligors, securities, and/or money market instruments were assigned a credit rating at this notch as of the start date. The transition rates from this notch to a lower notch are: 15% (BB), 10% (B), 6% (CCC), 5%

applicant and NRSRO to disclose the percent of obligors, securities, and money market instruments for which the applicant or NRSRO withdrew the credit rating for reasons other than Default or Paid Off during the period covered by the Transition/Default Matrix.[231] Investors and other users of credit ratings could use the percents of withdrawn credit ratings to assess whether the number of withdrawals impacted the transition and default rates entered in the Transition/Default Matrix.[232] They also would be able to compare historical withdrawal percents of an NRSRO and across all NRSROs. If an NRSRO has a disproportionate number of withdrawals for one period as compared to prior periods or as compared to those of other

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(CC), and 1% (C). Taken together, this means that 37% (or 1332) of the obligors, securities, and money market instruments were assigned a credit rating as of the end-date that was below BBB (i.e., in categories commonly referred to as "non-investment grade" or "speculative"). To lower the transition rates to "non-investment grade" categories, the credit ratings for 400 obligors, securities, or money market instruments assigned a BBB credit rating as of the start date could be withdrawn. This would reduce the transition rate to notches below BBB from 37% (1332/3600) to 26% (932/3600).

231 See proposed new paragraph (4)(B)(v) of the instructions for Exhibit 1.

232 For example, the 6th row of the Sample Transition/Default Matrix in Figure 1 represents the BB notch in the applicable rating scale. 1000 obligors, securities, and/or money market instruments were assigned a credit rating at this notch as of the start date. Of these 1000, 370 (or 37%) had their credit ratings withdrawn during the period (12/31/2000-12/31/2010). This amount is much larger than the withdrawal rates for the other notches, which range from 0% (AAA notch) to 12% (C notch). Moreover, the default rate for the BB notch (2%) is an anomaly in that it is lower than the default rate for the next highest notch BBB (4%). Normally, lower notches would be expected to have higher default rates. In addition, the AAA, AA, A, and BBB notches all have single digit default rates (ranging from 0% to 4%); whereas the notches below BBB all have double digit default rates (ranging from 15% to 67%), except for the BB notch (which, as noted, has a default rate of 2%). Furthermore, the two-notch downgrade transition rate for the BB notch is 5% (BB to CCC). This appears to be an anomaly given that the two-notch downgrade rates for the other notches are: 10% for the AA notch (AA to BBB); 10% for the A notch (A to BB); 10% for the BBB notch (BBB to B); 15% for the B notch (B to CC); 20% for the CCC notch (CCC to C); and 30% for the CC notch (CC to Default). An investor or other user of credit ratings reviewing this matrix could conclude that the withdrawal of credit ratings at the BB notch for reasons other than Default or Paid Off materially impacted the transition and default rates for the BB notch. The high rate of withdrawals in this instance also could be the focus of examination by the Commission staff.

NRSROs, investors and other users of credit ratings could consider that factor in assessing the veracity of the transition and default rates entered in the NRSRO's Transition/Default Matrix.

Request for Comment

The Commission generally requests comment on all aspects of the proposed new instructions for Exhibit 1 to Form NRSRO. The Commission also seeks comment on the following:

1. With respect to prescribing a standard method of calculating transition and default rates, would a single cohort approach (rather than an average cohort approach or some other approach)[233] be the most appropriate way to make the transition and default rates clear and informative for investors having a wide range of sophistication who use or might use credit ratings? Commenters should identify and explain any other approach they believe could be used to prescribe a standard process for calculating and presenting transition and default rates that would better achieve this goal.
2. What practical issues should the Commission consider in implementing a standard process for calculating and presenting transition and default rates? For example, would the variances in the procedures and methodologies NRSROs use to determine credit ratings raise practical issues in terms of adhering to a standard process for calculating and presenting transition and default rates? In addition, would the variances in the meanings and definitions NRSROs ascribe to the notches of credit ratings in their rating scales raise practical issues in terms of adhering to a standard process for calculating and presenting

233 An average cohort approach for calculating rating transitions or default statistics consists of taking the average of several cohorts over a longer time period. For example, the one-year average transition rate would be calculated by taking the average transition rate from several one-year cohorts over a given time period.

transition and default rates? How could the proposal be modified to address any practical issues identified without undermining the goal of comparability?

3. With respect to any practical issues identified in response to the solicitation of comment in question #2, would the proposed single cohort approach for calculating and presenting transition and default rates heighten or lessen the issues relative to other possible approaches such as the average cohort approach? Commenters should identify and explain any other approach they believe could be used to prescribe a standard process for calculating and presenting transition and default rates that would raise the least practical issues.
4. Would the proposals require an NRSRO to disclose proprietary information? If so, describe the type or types of proprietary information. Also, describe potential ways to address this issue.
5. Would the proposals have an impact on competition? For example, would they advantage or disadvantage a certain type of NRSRO? Could they potentially alter the behavior of NRSROs? For example, could the proposals cause certain NRSROs to stop determining a particular type of credit rating? If so, describe whether there would be any costs or negative impacts as a result and, if so, how such costs or negative impacts could be addressed.
6. How would the proposals differ from the way NRSROs currently calculate and present transition and default rates? For example, would they be more or less sophisticated than current methods? Would they be more or less burdensome than current methods? Describe the differences. Furthermore, describe the benefits of a standardized approach

in terms of making the disclosure more useful to investors and other users of credit ratings.

7. Would dividing the class of credit ratings for structured finance products into the subclasses identified in proposed paragraphs (1)(D)(i) through (vii) of the instructions for Exhibit 1 provide investors and other users of credit ratings with more useful information about the performance of an NRSRO's structured finance ratings? For example, should the Commission continue to require transition and default rates for this class only as a whole? If so, explain how this would provide more useful information about the performance of an NRSRO's structured finance ratings.
8. Are the subclasses of credit ratings for structured finance products identified in proposed paragraphs (1)(D)(i) through (vii) of the instructions for Exhibit 1 the most appropriate way to stratify this class of credit ratings? For example, should the "other-ABS" subclass be divided up into subclasses based on the assets underlying the ABS (i.e., auto loans, auto leases, floor plan financings, credit card receivables, student loans, consumer loans, equipment loans or equipment leases)? In addition, are there other classes of structured finance products that should be identified in proposed paragraph (1)(D) of the instructions for Exhibit 1?
9. Are the descriptions of the subclasses of credit ratings for structured finance products identified in proposed paragraphs (1)(D)(i) through (vii) of the instructions for Exhibit 1 sufficiently clear to provide an applicant and NRSRO with guidance as to which credit ratings should be included in the production of the Transition/Default Matrices for each subclass? How could the descriptions be modified to make them clearer and provide better guidance?

10. Would the design and presentation of a Transition/Default Matrix prescribed in proposed paragraph (3) of the instructions for Exhibit 1 be clear and informative for investors having a wide range of sophistication who use or might use credit ratings? How could the design and presentation of the Transition/Default Matrix be modified to better achieve this goal?

11. Would the design and presentation of a Transition/Default Matrix prescribed in proposed paragraph (3) of the instructions for Exhibit 1 be an appropriate way to present transition and default rates? How could the design and presentation of the Transition/Default Matrix be modified to better accommodate these statistics?

12. Are the instructions in proposed paragraphs (1), (2), (3), and (4) of Exhibit 1 sufficiently clear in terms of requirements for producing the required Transition/Default Matrices and presenting necessary information in the Exhibit? For example, are instructions in the paragraphs sufficiently clear in terms of the requirements for populating the columns and rows of a Transition/Default Matrix? How could the instructions be modified to make them clearer and provide better guidance?

13. Should obligors, securities, and money market instruments that an applicant or NRSRO has classified as being in default as of the start date of a period covered by a Transition/Default Matrix be excluded from the start-date cohort for that matrix? If not, explain the rationale for including them.

14. Should the start-date cohorts for the Transition/Default Matrices be comprised of obligors only (i.e., not include securities or money market instruments assigned credit ratings in the class or subclass)? For example, if the credit ratings of securities or money instruments issued by an obligor are simply a function of the credit rating of the obligor,

would it be sufficient to include only the obligor in the start-date cohort? If so, should this be the case for all classes and subclasses of credit ratings or for certain classes and subclasses? For example, the credit ratings assigned to securities and money market instruments in the structured finance class often are based on differing levels of credit enhancement specific to each tranche of a security issued by the obligor. Consequently, in such a case, the credit rating of the security or money market instrument issued would not be a function solely or primarily of the credit rating of the obligor.

15. Commenters are referred to the questions in Section II.M.4.a of this release with respect Items 6 and 7 of Form NRSRO and how certain types of obligors, securities, and money market instruments should be classified for purposes of providing approximate amounts of credit ratings outstanding in each class of credit rating for which an applicant is seeking registration (Item 6) or an NRSRO is registered (Item 7)? In responding to those questions, commenters should consider how proposed classifications could be applied to determining the composition of start-date cohorts for the purposes of the proposed enhancements to Exhibit 1.
16. Should the default rates in the Transition/Default Matrices be determined using the proposed standard definition of Default? For example, would the use of a standard definition raise practical issues in light of the different meanings that NRSROs ascribe to the notches in their credit rating scales or the different definitions of "default" they utilize? How could the proposal be modified to address any practical issues identified without undermining the goal of comparability?
17. Is the proposed standard definition of Default sufficiently broad to apply to most, if not all, events commonly understood as constituting a default? For example, should the

definition explicitly include that the obligor or issuer of the security or money market instrument is in a bankruptcy proceeding or would this be redundant in that the definition already provides that the obligor or issuer of the security has failed to timely pay interest or principal due? In addition, should the definition explicitly include events that would constitute a default due to a breach of a covenant unrelated to the failure to timely pay interest or principal due on a security or money market instrument (e.g., a covenant might provide that a default by the issuer on a bank loan to a third party or a default by an affiliate of the issuer would constitute a default with respect to a rated security of the issuer)? Would it be appropriate to include such cross-default provisions as part of the definition of the Default in the instructions for Exhibit 1? For example, if the issuer continued to make timely payments of interest and principal to the holders of the security notwithstanding the cross-defaults, would it nonetheless be appropriate to classify the security as in Default? If so, how could the proposed definition be modified to make it broad enough to apply to all instances of default? Should the requirement provide for an NRSRO to be able to use its own definition if the standard definition would not be feasible given the NRSRO's procedures and methodologies for determining credit ratings? If so, should the NRSRO be required to make disclosures about why it is using its own definition? Describe the nature of such disclosures.

18. Should the proposed standard definition of Default be refined to distinguish between degrees of default severity? For example, should the definition distinguish between a situation where an obligor or the issuer of a security or money market instrument has failed to make a timely payment of interest or principal that potentially could be cured and the situation where the obligor or issuer of the security or money market instrument

is no longer able to cure a failed payment of interest or principal or is in a bankruptcy proceeding? How could the proposed definition be modified to account for relative degrees of default severity and how should such modifications be incorporated into the proposed instructions for calculating default statistics?

19. Is the proposed standard definition of Paid Off sufficiently broad to apply to most, if not all, events commonly understood as constituting the extinguishment of an obligation upon which a credit rating is based? If not, how could the proposed definition be modified to make it broad enough to apply to all instances that should, for the purposes of transition and default rates, be classified as having Paid Off? Should the requirement provide for an NRSRO to be able to use its own definition if the standard definition would not be feasible given the NRSRO's procedures and methodologies for determining credit ratings? If so, should the NRSRO be required to make disclosures about why it is using its own definition? Describe the nature of such disclosures.

20. Would the proposed treatment for Withdrawn (other) credit ratings in the Transition/Default Matrices sufficiently address the concern that an applicant or NRSRO might use withdrawals to make its transition and default rates appear more favorable? For example, should the Commission, by rule, require an NRSRO to monitor an obligor, security, or money market instrument after withdrawal in order to classify whether the obligor, security, or money market instrument went into Default or Paid Off? If so, how long should the applicant or NRSRO be required to monitor the obligor, security, or money market instrument? Alternatively, should the applicant or NRSRO be required to explain and disclose in Exhibit 1 the reason why it withdrew the credit ratings in the given class or subclass of credit ratings? If so, how much detail should the applicant or

NRSRO provide in the description? Should the requirement provide for an NRSRO to be able to use its own definition if the standard definition would not be feasible given the NRSRO's procedures and methodologies for determining credit ratings? If so, should the NRSRO be required to make disclosures about why it is using its own definition? Describe the nature of such disclosures.

### b. Proposed Amendments to Rule 17g-1

Section 15E(q)(2)(D) of the Exchange Act provides that the Commission's rules must require an NRSRO to make the information about the performance of credit ratings freely available and disclose it on an easily accessible portion of its website, and in writing when requested.[234] The Commission proposes to implement Section 15E(q)(2)(D) by amending paragraph (i) of Rule 17g-1.[235] Paragraph (i) requires an NRSRO to make its current Form NRSRO and information and documents submitted in Exhibits 1 though 9 publicly available on its website or through another comparable, readily accessible means within 10 business days of being granted an initial registration or a registration in an additional class of credit ratings, and within 10 business days of furnishing a Form NRSRO to update information on the Form, to provide the annual certification, and to withdraw a registration.[236] These requirements implemented Section 15E(a)(3) of the Exchange Act,[237] which provides, among other things, that the Commission shall, by rule, require an NRSRO, upon the granting of a registration, to make the information and documents submitted to the Commission in its completed application for

234 See 15 U.S.C. 78o-7(q)(2)(D).

235 See proposed amendments to paragraph (i) of Rule 17g-1.

236 See 17 CFR 240.17g-1(i).

237 15 U.S.C. 78o-7(a)(3).

registration, or in any amendment, publicly available on its Internet website, or through another comparable, readily accessible means.[238]

Although Section 15E(q)(2)(D) only addresses disclosures of information about the performance of credit ratings, the Commission is proposing to amend paragraph (i) of Rule 17g-1 to require an NRSRO to make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website. This would avoid having separate requirements for the Exhibit 1 performance statistics and the rest of Form NRSRO and the other public Exhibits. The Commission preliminarily believes users of credit ratings would benefit if Form NRSRO and all the public Exhibits were disclosed together in the same manner. In addition, the Commission preliminarily believes applying the requirement to disclose the information on an "easily accessible" portion of the NRSRO's corporate Internet website would assist investors and other users of credit ratings by making it easier to locate a Form NRSRO. For example, some corporate Internet websites contain large amounts of information, some of which must be accessed by navigating through multiple web pages. The Commission believes Form NRSRO and the public Exhibits should be easy for investors and other users of credit ratings to locate when they access an NRSRO's corporate Internet website. In this regard, the Commission preliminarily believes that a Form NRSRO would be on an "easily accessible" portion of a website if it could be accessed through a clearly and prominently labeled hyperlink to the Form on the home-page of the NRSRO's corporate Internet website.

The proposed amendment to paragraph (i) also would remove the option for an NRSRO to make its Form NRSRO publicly available "through another comparable, readily accessible means" as an alternative to Internet disclosure. The Commission preliminarily believes there is

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238 See 15 U.S.C. 78o-7(a)(3).

no alternative means of disclosure that makes information as "readily accessible" as (and, therefore, is comparable to) an Internet website. This view is supported by the fact that all NRSROs currently comply with paragraph (i) of Rule 17g-1 by making their Form NRSROs available on their corporate Internet websites.[239] The Commission, therefore, is proposing amending paragraph (i) to require that the disclosure of Form NRSRO and its public Exhibits be made on an NRSRO's corporate Internet website without exception.[240] In addition, to implement Section 15E(q)(2)(D) of the Exchange Act, the Commission is proposing to amend paragraph (i) to provide that Exhibit 1 must be made freely available in writing, when requested.

Finally, the Commission notes that throughout Form NRSRO and the Instructions to Form NRSRO there are references to the current requirement in paragraph (i) to make Form NRSRO and information and documents submitted in Exhibits 1 though 9 "publicly available on [the NRSRO's] website or through another comparable, readily accessible means.[241] The Commission proposes amending all these references so that they would mirror the text of the proposed amendment to paragraph (i).

Request for Comment

The Commission generally requests comment on all aspects of the proposed amendments to paragraph (i) of Rule 17g-1. The Commission also seeks comment on the following:

1. Is there any reason why the Commission should not apply the requirement to make an NRSRO's performance statistics "freely available on an easily accessible portion of its

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239 See Annual Report on Nationally Recognized Statistical Rating Organizations. Commission (Jan. 2011), pp. 18-19.

240 See proposed amendments to paragraph (i) of Rule 17g-1.

241 See, e.g., references in Item 5, in the Note to Item 6.C, Item 8, and Item 9 of Form NRSRO and Instruction A.3 and Instruction H to Form NRSRO.

website" to Form NRSRO and the public Exhibits as a whole? For example, should the requirement apply only to Exhibit 1?

2. Is the Commission correct in its preliminary belief that a Form NRSRO would be on an "easily accessible" portion of a website if it could be accessed through a clearly and prominently labeled hyperlink to the Form on the home-page of the NRSRO's corporate Internet website? Are there other portions of an NRSRO's corporate Internet website that, provided the NRSRO placed a hyperlink to Form NRSRO on such portion of the website, should be deemed "easily accessible"?
3. Is there another means of making Form NRSRO publicly available besides the Internet that should be deemed "another comparable, readily accessible means"? If so, identify the means and explain the potential advantages of permitting it as a means of disclosure.
4. With respect to the proposed requirement that Exhibit 1 be made freely available in writing, when requested, how should an NRSRO meet such a request? For example, should an NRSRO be required to mail a written copy of Exhibit 1 to a party requesting the Exhibit? If so, would it be appropriate to permit the NRSRO to charge reasonable handling and postage fees? For example, would allowing an NRSRO to charge a reasonable handling and postage fee discourage requests that are not based on a legitimate need to obtain Exhibit 1 in paper form? In this regard, the Commission notes that Exhibit 1 currently can be immediately accessed through an NRSRO's corporate Internet website and, under the proposed amendments to paragraph (i) of Rule 17g-1, would need to be posted on an easily accessible portion of the NRSRO's corporate Internet website. Consequently, why would a person have a legitimate need to request that an NRSRO provide Exhibit 1 in paper form (which would take time to process the

request and send out the Exhibit) when it could be obtained immediately through the Internet?

### 2. Proposed Enhancements to Rating Histories Disclosures

Paragraph (a)(8) of Rule 17g-2 requires an NRSRO to make and retain a record that, "for each outstanding credit rating, shows all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key ("CIK") number of the rated obligor."[242] An NRSRO is required to retain this record for three years pursuant to paragraph (c) of Rule 17g-2.[243]

In addition, paragraph (d) of Rule 17g-2 requires the NRSRO to publicly disclose certain of this information as well. Specifically, paragraph (d)(2) of Rule 17g-2 requires an NRSRO to "make and keep publicly available on its corporate Internet Website in an eXtensible Business Reporting Language ("XBRL") format" the information required to be documented pursuant to paragraph (a)(8) of Rule 17g-2 for 10% of the outstanding credit ratings, selected on a random basis, in each class of credit rating for which the NRSRO is registered if the credit rating was paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated ("issuer-paid" credit ratings) and the NRSRO has 500 or more such issuer-paid credit ratings outstanding in that class (the "10% Rule").[244] Paragraph (d)(2) further provides that any ratings action required to be disclosed need not be made public less than six months from the

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242 17 CFR 240.17-2(a)(8). A CIK number has ten-digits and is assigned to uniquely identify a filer using the Commission's EDGAR system.

243 See 17 CFR 240.17g-2(c).

244 17 CFR 240.17-2(d)(2).

date the action is taken.[245] This six-month grace period is designed to preserve the ability of NRSROs to sell data feeds to the portfolios of their current credit ratings by making the information disclosed in the 10% Rule out-of-date.[246] Paragraph (d)(2) also requires that, if a credit rating made public pursuant to the rule is withdrawn or the rated instrument matures, the NRSRO must randomly select a new outstanding credit rating from that class of credit ratings in order to maintain the 10% disclosure threshold.[247] Finally, paragraph (d)(2) provides that in making the information available on its corporate Internet website, the NRSRO must use the List of XBRL Tags for NRSROs as specified on the Commission's Internet website.[248]

Paragraph (d)(3) of Rule 17g-2 requires an NRSRO to make publicly available on its corporate Internet website information required to be documented pursuant to paragraph (a)(8) of the rule for any credit rating initially determined by the NRSRO on or after June 26, 2007, the effective date of the Rating Agency Act of 2006 (the "100% Rule").[249] The 100% Rule applies to all types of credit ratings, as opposed to the 10% Rule, which is limited to issuer-paid credit ratings. However, paragraphs (d)(3)(i)(B) and (C) prescribe different grace periods for when an NRSRO must disclose a rating action depending on whether or not it was issuer-paid.[250] Specifically, paragraph (d)(3)(i)(B) provides that if the credit rating is issuer-paid, then the grace

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245 Id.

246 The fact that the disclosure involves only a random sample of 10% of the outstanding credit ratings also limits the utility of the information disclosed in terms of serving as a substitute to purchasing a data feed to the NRSRO's current portfolio of outstanding credit ratings.

247 17 CFR 240.17-2(d)(2).

248 Id.

249 17 CFR 240.17-2(d)(3).

250 17 CFR 240.17-2(d)(3)(i)(B) and (C).

period is 12 months after the date the action is taken.[251] Similar to the 6-month grace period in the 10% Rule, this 12-month grace is designed to preserve the ability of NRSROs to sell data feeds to their portfolios of current outstanding credit ratings by making the information disclosed in the 100% Rule out-of-date.[252] For all non-issuer paid credit ratings, paragraph (d)(3)(i)(C) provides a grace period of 24 months after the date the rating action is taken. This longer grace period is designed to address the "subscriber-paid" business model in which the NRSRO makes its credit ratings available for a fee rather than for free.[253] Paragraph (d)(3)(ii) of Rule 17g-2 requires the NRSRO to disclose the ratings history information on its corporate Internet website in an XBRL format using the List of XBRL Tags for NRSROs as published by the Commission on its Internet website.[254]

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251 17 CFR 240.17-2(d)(3)(i)(B).

252 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63837-63842 (Dec. 4, 2009) (discussing the grace periods in the rule).

253 Id.

254 At the time the 10% Rule became effective (which preceded the 100% Rule), the Commission had not published the List of XBRL Tags. Consequently, the Commission issued a notice that NRSROs could use any machine readable format to publish the ratings history information required by the 10% Rule. See Notice Regarding the Requirement to Use eXtensible Business Reporting Language Format to Make Publicly Available the Information Required Pursuant to Rule 17g-2(d) of the Exchange Act, Exchange Act Release No. 60451 (Aug. 5, 2009). On August 27, 2010, the Commission provided notice that the List of XBRL tags required to be used for purposes of the 10% Rule and, the subsequently adopted 100% Rule, was available on the Commission's Internet website. See Notice Regarding the Requirement to Use eXtensible Business Reporting Language Format to Make Publicly Available the Information Required Pursuant to Rule 17g-2(d) of the Exchange Act, Exchange Act Release No. 62784 (Aug. 27, 2010), 75 FR 53988 (Sept. 2, 2010). Information about the List of XBRL Tags is located at the following page on the Commission's website: http://www.sec.gov/spotlight/xbrl/nrsro-implementation-guide.shtml. The publication of this notice in the Federal Register triggered the 60-day period after which NRSROs were required to begin using an XBRL format for purposes of the two rules. The 60-day period ended on November 1, 2010. The XBRL Tags identified by the Commission include mandatory tags with respect to the information specifically identified in paragraph (a)(8) of Rule 17g-2 (17 CFR 240.17g-2(a)(8)) (i.e., the date of the rating

The Commission is proposing amendments designed to enhance the utility of the 100% Rule.[255] Moreover, in light of the proposed amendments to the 100% Rule (discussed below) and Exhibit 1 (discussed above), the Commission is proposing to repeal the 10% Rule. The 10% Rule does not permit comparability across NRSROs because it captures only issuer-paid credit ratings in a class of credit ratings where there are 500 or more such ratings and only if two or more NRSROs randomly select the same rated obligor, issuer, or money instrument to be included in the sample.[256] Moreover, the Commission understands that the 10% Rule may not produce sufficient "raw data" to allow third parties to generate independent performance statistics.[257] The goal of the rule was to provide some information about how an NRSRO's credit ratings performed, particularly ratings assigned to obligors, securities and money market instruments that had been rated for 10 or 20 years. The Commission now preliminarily believes that, in light of the proposed enhancements to Exhibit 1 and the 100% Rule, the 10% Rule would provide minimal incremental benefit to investors and other users of credit ratings in terms of providing information about the performance of a given NRSRO's credit ratings.

With respect to the 100% Rule, the Commission is proposing its provisions be moved from Rule 17g-2 (the NRSRO recordkeeping rule) to Rule 17g-7.[258] Currently, Rule 17g-7

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action, the credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the CIK number of the rated obligor). The XBRL Tags also identify additional information that could be tagged by the NRSRO to enhance the disclosure.

255 See, e.g., GAO Report 10-782, p. 40 ("However, we found that the data disclosed under the 10 percent sample disclosure requirement do not contain enough information to construct comparable performance statistics and are not representative of the population of credit ratings at each NRSRO and that the data disclosed under the 100 percent disclosure requirement likely present similar issues.").

256 See, e.g., GAO Report 10-782, pp. 40-47.

257 Id.

258 17 CFR 240.17g-7.

requires an NRSRO to disclose certain information in any report accompanying an asset-backed security.[259] In other words, the rule requires an NRSRO to publicly disclose information outside of Form NRSRO (the predominant NRSRO disclosure rule). Similarly, the 100% Rule in its current form (and as proposed) also requires (and would require) an NRSRO to disclose information outside of Form NRSRO. Finally, as discussed below in Section II.G of this release, Section 15E(s) of the Exchange Act provides that the Commission shall adopt rules to require an NRSRO to disclose further information outside of Form NRSRO.[260] The Commission is proposing to consolidate non-Form NRSRO disclosure rules by codifying them in Rule 17g-7.[261]

The proposed enhancements to the 100% Rule would be codified in new paragraph (b) of Rule 17g-7.[262] Proposed paragraph (b)(1) would require, among other things, that the NRSRO publicly disclose the ratings history information for free on an easily accessible portion of its corporate Internet website.[263] This would implement Section 15E(q)(2)(D) of the Exchange Act and, by using the "easily accessible portion" language, enhance the current requirement of the 100% Rule that the ratings history information be disclosed on the NRSRO's corporate Internet

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259 See 17 CFR 240.17g-7, which requires an NRSRO to include in any report accompanying a credit rating with respect to an asset-backed security, as that term is defined in Section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)) a description of: the representations, warranties and enforcement mechanisms available to investors; and how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. Id.

260 See 15 U.S.C. 78o-7(s).

261 See 15 U.S.C. 78o-7 and 15 U.S.C. 78q. The current provisions of Rule 17g-7 would be incorporated into new paragraph (a) of Rule 17g-7 as discussed below in Section II.G of this release. The Commission notes that some NRSROs may (or could in the future) have additional disclosure requirements based on their status as another type of registrant or because they are part of a company that has filing obligations under other provisions of the securities laws. The Commission does not intend to consolidate such other disclosure requirements in Rule 17g-7.

262 See proposed new paragraph (b) of Rule 17g-7.

263 See proposed new paragraph (b)(1) of Rule 17g-7.

website.[264] As discussed above in Section II.E.1.b of this release, some Internet websites contain large amounts of information, some of which must be accessed by navigating through multiple web pages.[265] Consequently, as discussed, the Commission preliminary believes that Form NRSRO would be on an "easily accessible" portion of an Internet website if it could be accessed through a clearly and prominently labeled hyperlink to the Form on the homepage of the NRSRO's corporate Internet website. The Commission preliminarily believes that the same holds true for the disclosure of the data file or files containing the information that would be required by the enhanced 100% Rule.[266]

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264 See 15 U.S.C. 78o-7(q)(2)(D); compare 17 CFR 240.17g-7(d)(3)(i)(A), with proposed new paragraph (b) of Rule 17g-7. As discussed above, Section 15E(q)(2)(D) of the Exchange Act provides that the Commission's rules shall require the information about the performance of credit ratings be published and made freely available by the NRSRO, on an easily accessible portion of its website, and in writing, when requested. Id. The Commission, however, preliminarily believes that the "in writing" requirement would not be feasible if applied to the disclosures of rating histories. First, the data file containing the disclosures would need to be constantly updated by the NRSRO as new rating actions are added. Thus, it would not remain static like the Exhibit 1 performance measurement statistics which are updated annually. Consequently, by the time a party received a written copy of the disclosure, it likely would not be up-to-date. Second, the amount of information in the data file would be substantial (particularly for NRSROs that have issued hundreds of thousands of credit ratings) and increase over time. For these reasons, the Commission preliminarily believes that converting the information in the electronic disclosure to written form and mailing it to the party making the request would be impractical and not particularly useful. In terms of utility, as discussed below, the electronic disclosure of the data would need to be made using an XBRL format. The Commission preliminarily believes this would be a much more efficient and practical medium for accessing and analyzing the information rather than obtaining it in paper form. Consequently, the Commission preliminarily believes that the benefits, if any, to requiring a written disclosure would be limited. However, the Commission is requesting comment below on this issue.

265 See Section II.E.1.b of this release proposing amendments to paragraph (i) of Rule 17g-1 to implement Section 15E(q)(2)(D) of the Exchange Act. 15 U.S.C. 78o-7(q)(2)(D). Under the proposals, an NRSRO would need to make Form NRSRO and Exhibits 1 through 9 "freely available on an easily accessible portion of its website." See proposed amendments to paragraph (i) of Rule 17g-1.

266 See 15 U.S.C. 78o-7(q)(2)(D).

The next enhancement to the 100% Rule proposed by the Commission is to substantially broaden the scope of credit ratings that would be subject to the disclosure requirements. The Commission's intent is to require disclosure of information about all outstanding credit ratings in each class and subclass of credit ratings for which the NRSRO is registered but within certain prescribed time frames. As noted above, the 100% Rule currently only captures credit ratings where the NRSRO initially determined a credit rating for the obligor, security, or money market instrument on or after June 26, 2007.[267] This means that obligors, securities, and money market instruments assigned a credit rating by the NRSRO before that date are excluded entirely from the disclosure even if a rating action is taken with respect to the obligor, security, or money market instrument after that date. Consequently, if a user of the disclosures wanted to calculate a transition or default rate for a given NRSRO's credit ratings, the user could not compile a start-date cohort that included all obligors, securities, or money market instruments assigned a credit as of the start date.[268] The Commission's proposal would be designed to address this issue.[269]

In particular, the Commission is proposing that the rule no longer be limited to the disclosure of histories for credit ratings where the NRSRO initially determined a credit rating for

267 See 17 CFR 240.17g-2(d)(3)(i)(A).

268 See, e.g., GAO Report 10-782, p. 45. This issue is particularly acute when the NRSRO determines credit ratings for obligors in only one class of credit ratings. As discussed earlier, obligor credit ratings typically provide an assessment of the relative creditworthiness of the obligor as an entity for all its obligations. Thus, it is different from a credit rating for a security or money instrument that typically has a single finite obligation that will mature, be called, or be prepaid (if it does not default). An NRSRO that primarily issued obligor credit ratings in a class and initially rated them prior to June 26, 2007 would never have to include the rating histories of these obligors in the disclosure. For example, the NRSRO could be monitoring credit ratings for the same group of obligors that were initially rated 10 to 20 years ago. In this case, the NRSRO would have no ratings histories to disclose.

269 See, e.g., GAO Report 10-782, pp. 45-46.

the obligor, security, or money market instrument on or after June 26, 2007.[270] Instead, the rule, as proposed, would apply to any credit rating that was outstanding as of June 26, 2007, but the rating histories disclosed for these credit ratings would not need to include information about actions taken before June 26, 2007.[271] Moreover, in order to immediately include these credit ratings in the disclosure, the proposed rule would require the NRSRO to disclose the credit rating assigned to the obligor, security, or money market instrument and associated information as of June 26, 2007. Specifically, proposed paragraph (b)(1)(i) of Rule 17g-7 would require an NRSRO to disclose each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the NRSRO is registered that was outstanding as of June 26, 2007 and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument.[272] Consequently, an NRSRO would need to include in the XBRL file through which it makes the rating history disclosures all outstanding credit ratings as of June 26, 2007 (i.e., not wait until a new rating action was taken with respect to the credit rating) and then disclose subsequent actions taken with respect to those credit ratings. In other words, the histories for this class of credit ratings would begin on June 26, 2007. This would mean that the disclosures would not contain complete histories for many

270 See proposed new paragraph (b)(1)(i) of Rule 17g-7.

271 The Commission notes, however, that an NRSRO could voluntarily disclose more rating history information than required by the current rule or the proposed amendment to the rule.

272 Id.

credit ratings.[273] However, the disclosures would capture all outstanding credit ratings in each class of credit ratings for which the NRSRO is registered and, therefore, market participants could immediately begin computing short-term transition and default rates using start-date cohorts that include all the obligors, securities, and money market instruments assigned a credit rating in a given class.[274]

Proposed paragraph (b)(1)(ii) of Rule 17g-7 would contain the existing requirement in the 100% Rule that an NRSRO disclose rating histories for each credit rating in every class of credit ratings for which the NRSRO is registered that was initially determined on or after June 26, 2007 and any subsequent rating action taken with respect to such credit ratings.[275] Specifically, proposed paragraph (b)(1)(ii) would require the NRSRO to disclose each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the NRSRO is registered that was initially determined on or after June 26, 2007, and any

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273 For example, assume an obligor was initially rated in AA on June 26, 2000. Thereafter, the rating was downgraded to AA- on June 26 2003, to A on June 26, 2005, and to BBB on June 26, 2008. Under the proposed rule, the ratings history disclosure would cross the June 26, 2007 threshold with an A rating. The history for this obligor would omit the initial AA rating on June 26, 2000 and the downgrades to AA- and A on June 26, 2003 and June 26, 2005, respectively. Therefore, the first event in the rating history would be that the obligor was assigned an A rating as of June 26, 2007. The next event in the rating history would be the downgrade of the credit rating to BBB on June 26, 2008.

274 For example, a user of the credit rating histories would be able to generate transition and default rates for a period having a start date as far back as June 26, 2007. In doing so, the user would be able to compile a start-date cohort consisting of all the obligors, securities, and money market instruments assigned an outstanding credit rating in a given class as of June 26, 2007. The user could compute transition and default rates over short-term periods (i.e., 1 or 2 years) in the near term and for longer periods as time progresses and more ratings actions over a longer time horizon are added to the disclosure. In addition, the user could calculate transition or default rates using a different process than the single cohort approach proposed for the Exhibit 1 disclosures. For example, the user could begin calculating short-term transition and default rates using a rolling average in which start-date cohorts are identified each month (e.g., June 26, 2007, July 26, 2007, August 26, 2007, and so on).

275 See proposed new paragraph (b)(1)(ii) of Rule 17g-7.

subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument. Consequently, the disclosure mandated under proposed paragraph (b)(1) of Rule 17g-7 would capture all credit ratings outstanding as of June 26, 2007 (regardless of when the obligor, security, or money market instrument was initially assigned a credit rating) and the subsequent rating actions taken with respect to those credit ratings as well as all credit ratings initially determined on or after that date and the subsequent rating actions taken with respect to those credit ratings.[276]

The next enhancement to the 100% Rule proposed by the Commission is to increase the number and scope of the data fields that must be disclosed about a rating action.[277] Specifically, proposed paragraph (b)(2) of Rule 17g-7 would identify 7 categories of data that would need to be disclosed when a credit rating action is published pursuant to proposed new paragraph (b)(1) of Rule 17g-7. In addition, some of the categories would have sub-categories.[278] The goal would be to make the data more useful in terms of the amount of information provided, the ability to search and sort the information, and the ability to compare historical rating information across NRSROs.[279]

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276 See proposed new paragraph (b)(1) of Rule 17g-7.

277 See proposed new paragraph (b)(2) of Rule 17g-7.

278 If adopted, the Commission would need to update the List of XBRL Tags to include some of the new data fields; whereas other of the fields are covered by existing Tags, including by some of the voluntary Tags.

279 See, e.g., GAO Report 10-782, p. 41 ("First, SEC [sic] did not specify the data fields the

Proposed new paragraph (b)(2)(i) of Rule 17g-7 would identify the first category of data: namely, the identity of the NRSRO disclosing the rating action.[280] This may seem unnecessary as the identity of the NRSRO making the disclosure should be obvious. However, as noted above, the NRSRO would need to assign an XBRL Tag to each item of information, including the identity of the NRSRO. Including and tagging the identity of the NRSRO would assist users who download and combine data files of multiple NRSROs to sort credit ratings by a given NRSRO.

Proposed new paragraph (b)(2)(ii) of Rule 17g-7 would identify the second category of data: namely, the date of the rating action.[281] This proposed requirement is in the 100% Rule as it exists today.[282] The inclusion of the date of a rating action is designed to allow investors and other users of credit ratings to review the timing of a rating action.[283] This would allow the person reviewing the credit rating histories of the NRSROs to reach conclusions about which

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NRSROs were to disclose in the rule, and the data fields provided by the NRSROs were not always sufficient to identify a complete rating history for ratings in each of the seven samples. If users cannot identify the rating history for each rating in the sample, they cannot develop performance measures that track how an issuer's credit rating evolves.").

280 See proposed new paragraph (b)(2)(i) of Rule 17g-7.

281 See proposed new paragraph (b)(2)(ii) of Rule 17g-7. The Commission notes that many of the rating actions in an NRSRO's disclosure would share the date of June 26, 2007, which would be the first action disclosed for rating histories of credit ratings initially determined before June 26, 2007. This would result from the proposed requirement to add all credit ratings outstanding as of June 26, 2007 to the disclosure. See proposed new paragraph (b)(1)(i) of Rule 17g-7. As discussed below, the Commission is proposing that this action (the adding of an outstanding credit rating) have a unique XBRL tag so that persons using these disclosures do not confuse the action as an initial credit rating or change to an existing credit rating (e.g., an upgrade or a down grade). See proposed new paragraph (b)(2)(v)(A) of Rule 17g-7.

282 See 17 CFR 240.17g-2(a)(8).

283 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63837-63838 (Dec. 4, 2009).

NRSROs did the best job in determining an initial rating and, thereafter, making appropriate and timely adjustments to the credit rating.[284]

Proposed new paragraph (b)(2)(iii) of Rule 17g-7 would identify the third category of data.[285] The information in this category would need to be disclosed if the rating action is taken with respect to an obligor (i.e., as opposed to a credit rating of a security or money market instrument). In this case, the NRSRO would need to disclose (if applicable): (1) the CIK number of the rated obligor; and (2) the legal name of the obligor. This proposed requirement is in the 100% Rule as it exists today.[286]

Proposed new paragraph (b)(2)(iv) of Rule 17g-7 would identify the fourth category of data.[287] The information in this category would need to be disclosed when the rating action is taken with respect to a security or money market instrument. In this case, the NRSRO would need to disclose (if applicable): (1) the CIK number of the issuer of the security or money market instrument; (2) the legal name of the issuer of the security or money market instrument; and (3) the CUSIP of the security or money market instrument.[288] The proposed requirement to include the CUSIP of security or money market instrument is in the 100% Rule as it exists today.[289] The requirements to include the name and CIK number of the issuer would be new. The Commission preliminarily believes including this information would be useful because it would allow users of the XBRL data file to sort credit ratings of securities and money market instruments by issuer.

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284 Id.

285 See proposed new paragraph (b)(2)(iii) of Rule 17g-7.

286 See 17 CFR 240.17g-2(a)(8).

287 See proposed new paragraph (b)(2)(iv) of Rule 17g-7.

288 CUSIP stands for the Committee on Uniform Securities and Identification. A CUSIP number consists of nine characters that uniquely identify a company or issuer and the type of security.

289 See 17 CFR 240.17g-2(a)(8).

Proposed paragraph (b)(2)(v) of Rule 17g-7 would identify the fifth category of data: namely, a classification of the type of rating action.[290] The NRSRO would be required to select 1 of 7 classifications to identify the reason for the rating action.[291] Aside from the first classification discussed below, the Commission preliminarily believes that the classifications identify all types of actions an NRSRO might take with respect to a credit rating.

The first classification would be that the rating action constitutes a disclosure of a credit rating that was outstanding as of June 26, 2007 for the purposes of proposed paragraph (b)(1)(i) of Rule 17g-7.[292] As discussed above, the Commission is proposing that the 100% rule capture all credit ratings outstanding as of June 26, 2007 by disclosing the credit rating and associated information as of that date.[293] If adopted, this would mean that thousands, if not hundreds of thousands, of ratings histories each beginning on June 26, 2007 would be disclosed. The proposed classification is designed to alert users of the disclosures that the proposed rule caused the June 26, 2007 entry in the rating history of the obligor, security, or money market instrument and not because, for example, a credit rating was initially determined for the obligor, security, or money market instrument on that date.

The second classification would be that the rating action was an initial credit rating.[294] For example, an NRSRO would select this classification if the rating action was the first credit

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290 See proposed paragraph (b)(2)(v) of Rule 17g-7.

291 The actual disclosure would need to be the type of rating action and not the credit rating resulting from the rating action. For example, if the rating action was a downgrade, the NRSRO would need to classify it as a "downgrade" and not, for example, a change of the current credit rating from the AA notch to AA- notch. This would allow users of the disclosures to sort the information by, for example, initial credit ratings, upgrades, and downgrades.

292 See proposed paragraph (b)(2)(v)(A) of Rule 17g-7.

293 See proposed paragraph (b)(1)(i) of Rule 17g-7.

294 See proposed paragraph (b)(2)(v)(B) of Rule 17g-7. The Commission is not proposing

rating determined by the NRSRO with respect to the obligor, security, or money market instrument. The third classification would be an upgrade to an existing credit rating.[295] The fourth classification would be a downgrade to an existing credit rating, which would include assigning a credit rating of default.[296] The fifth classification would be placing an existing credit rating on credit watch or review.[297] This means the NRSRO has disclosed that it is actively evaluating whether the credit rating should be changed. The sixth classification would be affirming the current credit rating assigned to the obligor, security, or money market instrument.[298] For example, an NRSRO may publish an announcement that it is affirming the current credit rating of an obligor, security, or money market instrument and, consequently, determine not to upgrade or downgrade the credit rating to a different notch in the rating scale.

The seventh classification would be the withdrawal of an existing credit rating.[299] In the case of a withdrawal, the NRSRO would be required to provide a sub-classification identifying

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that a rating action that results in an "expected" or "preliminary" credit rating be included in the rating history for a given obligor, security, or money market instrument. As noted above, expected or preliminary ratings most commonly are issued by an NRSRO with respect to a structured finance product at the time the issuer commences the offering and typically are included in pre-sale reports. These ratings may include a range of ratings, or any other indications of a credit rating used prior to the assignment of an initial credit rating for a new issuance. As such, the Commission preliminarily believes they should be excluded from the ratings histories since the issuance of the "initial" credit rating is the first formal expression of the NRSRO's view of the relative creditworthiness of the obligor, security, or money market instrument.

295 See proposed paragraph (b)(2)(v)(C) of Rule 17g-7.

296 See proposed paragraph (b)(2)(v)(D) of Rule 17g-7.

297 See proposed paragraph (b)(2)(v)(E) of Rule 17g-7.

298 See proposed paragraph (b)(2)(v)(F) of Rule 17g-7. Some NRSRO's also may "confirm" an existing credit rating. For the purposes of this proposed disclosure requirement, the Commission intends the term "affirmation of an existing credit rating" to include a "confirmation" of an existing credit rating.

299 See proposed paragraph (b)(2)(v)(G) of Rule 17g-7.

reason for the withdrawal.[300] There would be three sub-classifications: (1) the obligor defaulted, or the security or money market instrument went into default;[301] (2) the obligation subject to the credit rating was extinguished by payment in full of all outstanding principal and interest due on the obligation according to the terms of the obligation;[302] or (3) the credit rating was withdrawn for reasons other than those set forth in (1) and (2) above.[303] These sub-classifications would parallel, in many respects, the outcomes identified in paragraphs (4)(B)(iii), (iv), and (v) of the proposed amendments to the instructions for Exhibit 1 to Form NRSRO discussed above in Section II.E.1.a of this release. However, the Commission preliminarily believes that it would not be appropriate to prescribe standard definitions of "default" and "paid-off" for the purposes of making these classifications.[304] The reason is the ratings history disclosure requirement is designed to allow investors and other users of credit ratings to compare how each NRSRO treats a commonly rated obligor, security, or money market instrument. In other words, unlike the production of performance statistics where standard definitions are necessary to promote comparability of aggregate statistics, the historical rating information should indicate on the granular level any differences between the NRSROs with respect to the rating actions they take for a commonly rated obligor, security or money, market instrument, including their differing definitions of default. This would allow investors and other users of credit ratings to review, for

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300 See proposed paragraphs (b)(2)(v)(G)(1), (2) and (3) of Rule 17g-7.

301 See proposed paragraph (b)(2)(v)(G)(1) of Rule 17g-7.

302 See proposed paragraphs (b)(2)(v)(G)(2) of Rule 17g-7.

303 See proposed paragraphs (b)(2)(v)(G)(3) of Rule 17g-7.

304 For the reasons discussed herein, the Commission also preliminarily believes that the NRSRO should use its definition of "default" in taking a rating action that results in a downgrade to the default category, which would need to be classified as a downgrade in the information disclosed with the rating action pursuant to proposed paragraph (b)(2)(v)(D) of Rule 17g-7.

example, the timing of when one NRSRO downgraded an obligor to the default category as opposed to another NRSRO or group of NRSROs. Among other things, investors and other users of credit ratings could review the data to identify outliers that are either quick or slow to downgrade obligors, securities, or money market instruments to default. In addition, an NRSRO with a very narrow definition of "default" might continue to maintain a security at a notch in its rating scale above the default category; whereas other NRSROs, using broader definitions, had classified the security as having gone into default. Creating a mechanism to identify these types of variances is a goal of the enhancements to the 100% Rule. Moreover, users of the ratings history information could use the standard definition of Default in the proposed enhancements to the instructions for Exhibit 1 as a benchmark to compare when an NRSRO classified obligors, securities, or money markets as having gone into to default.

The Commission preliminarily believes a default and the extinguishment of an obligation because it was paid in full are the most frequently occurring reasons why an NRSRO withdraws a credit rating. However, as discussed above, in Section II.E.1.a of this release, there are other reasons an NRSRO might withdraw a credit rating, including that the rated obligor or issuer of the rated security or money market instrument stopped paying for the surveillance of rating or the NRSRO decided not to devote resources to continue to perform surveillance on the rating of an obligor, security, or money market instrument on an unsolicited basis. However, as also discussed above, the withdrawal of credit ratings could be used to make performance statistics appear more favorable. Consequently, as with the Transition/Default Matrices in Exhibit 1, an NRSRO would be required to identify when a credit rating was withdrawn for reasons other than default or the extinguishment of the obligation upon which the credit rating is based. Similar to the Transition/Default Matrices, persons using the ratings history information could analyze how often an NRSRO withdraws a credit rating for "other" reasons in a class or subclass of credit ratings.

Proposed paragraph (b)(2)(vi) of Rule 17g-7 would identify the sixth category of data: namely, a classification of the class or subclass of credit rating.[305] The classes of credit ratings would be based on the definition of "nationally recognized statistical rating organization" in Section 3(a)(62) of the Exchange Act.[306] Consequently, the first classification would be financial institutions, brokers or dealers.[307] The second classification would be insurance companies.[308] The third classification would be corporate issuers.[309]

The fourth classification would be issuers of structured finance products.[310] If the credit rating falls into this class, the proposed rule would require the NRSRO to identify a sub-classification as well.[311] The sub-classifications would be the same subclasses for structured finance credit ratings the Commission is proposing an applicant and NRSRO use for the

305 See proposed paragraph (b)(2)(vi) of Rule 17g-7.

306 See 15 U.S.C. 78o-7(a)(62). Because some obligors, securities, and money market instruments have characteristics that could cause them to be assigned more than one class of credit rating, the Commission is seeking comment below in Section II.M.4.a of this release on which class would be the most appropriate for certain types of obligors, securities, and money market instruments. Based on the comments received in response to those requests, the Commission may decide to prescribe by rule or identify through guidance how certain types of obligors, securities, and money market instruments should be classified for the purposes proposed new paragraph (b)(vi) of Rule 17g-7.

307 See 15 U.S.C. 78o-7(a)(62)(B)(i) and proposed paragraph (b)(2)(vi)(A) of Rule 17g-7.

308 See 15 U.S.C. 78o-7(a)(62)(B)(ii) and proposed paragraph (b)(2)(vi)(B) of Rule 17g-7.

309 See 15 U.S.C. 78o-7(a)(62)(B)(iii) and proposed paragraph (b)(2)(vi)(C) of Rule 17g-7.

310 See 15 U.S.C. 78o-7(a)(62)(B)(iv) and proposed paragraph (b)(2)(vi)(D) of Rule 17g-7. Consistent with the existing Instructions to Exhibit 1 to Form NRSRO (and the proposed amendments to those instructions) this class of credit rating would be broader than the class identified in Section 15E(a)(62)(B)(iv) of the Exchange Act.

311 See proposed paragraphs (b)(2)(vi)(D)(1)-(7) of Rule 17g-7.

purposes of the Transition/Default Matrices to be disclosed in Exhibit 1 to Form NRSRO:[312] RMBS;[313] CMBS;[314] CLOs;[315] CDOs;[316] ABCP;[317] other asset-backed securities;[318] and other structured finance products.[319]

The fifth classification would be issuers of government securities, municipal securities or securities issued by a foreign government.[320] If the credit rating falls into this class, the proposed rule would require the NRSRO to identify a sub-classification as well.[321] The sub-classifications

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312 See discussion in Section II.E.1.a of this release and proposed new paragraphs (1)(D)(i)-(vii) of the instructions for Exhibit 1.

313 See proposed paragraph (b)(2)(vi)(D)(1) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminarily intends that "RMBS" for the purposes of this rule means a securitization primarily of residential mortgages.

314 See proposed paragraph (b)(2)(vi)(D)(2) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminarily intends that "CMBS" for the purposes of this rule means a securitization primarily of commercial mortgages.

315 See proposed paragraph (b)(2)(vi)(D)(3) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminarily intends "CLO" for the purposes of this rule means a securitization primarily of commercial loans.

316 See proposed paragraph (b)(2)(vi)(D)(4) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminary intends "CDO" for the purposes of this rule to mean a securitization primarily of other debt instruments such as RMBS, CMBS, CLOs, CDOs, other asset backed securities, and corporate bonds.

317 See proposed paragraph (b)(2)(vi)(D)(5) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminarily intends "ABCP" for the purposes of this rule to mean short term notes issued by a structure that securitizes a variety of financial assets (e.g., trade receivables or credit card receivables), which secure the notes.

318 See proposed paragraph (b)(2)(vi)(D)(6) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminarily intends that "other asset backed security" for the purposes of this rule to mean a securitization primarily of auto loans, auto leases, floor plan financings, credit card receivables, student loans, consumer loans, equipment loans or equipment leases.

319 See proposed paragraph (b)(2)(vi)(D)(7) of Rule 17g-7. As with the proposal for Exhibit 1 to Form NRSRO, the Commission preliminarily intends that "other structured finance product" for the purposes of this rule to mean a structured finance product not identified in the other sub-classifications of structured finance products.

320 See 15 U.S.C. 78o-7(a)(62)(B)(v) and proposed paragraph (b)(2)(vi)(E) of Rule 17g-7.

321 See proposed paragraphs (b)(2)(vi)(E)(1)-(3) of Rule 17g-7.

would be the same for this class as are currently identified in the Instructions for Exhibit 1 to Form NRSRO: (1) Sovereign issuers;[322] (2) United States public finance;[323] or (3) International public finance.[324]

Proposed paragraph (b)(2)(vii) of Rule 17g-7 would identify the seventh category of data: namely, the credit rating symbol, number, or score in the applicable rating scale of the NRSRO assigned to the obligor, security, or money market instrument as a result of the rating action or, if the credit rating remained unchanged as a result of the action, the credit rating symbol, number, or score in the applicable rating scale of the NRSRO assigned to the obligor, security, or money market instrument as of the date of the rating action.[325] The rating symbol, number, or score is a key component of the information that would need to be disclosed as it reflects the NRSRO's view of the relative creditworthiness of the obligor, security, or money market instrument subject to the rating as of the date the action is taken. The proposal would specify that the NRSRO, in either case, would need to include a credit rating in a default category, if applicable. Otherwise an NRSRO might exclude a default on the theory that it is not a credit rating <u>per se</u> (<u>i.e.</u>, an opinion of creditworthiness) but rather a statement of fact.

Proposed paragraph (b)(3) of Rule 17g-7 would provide that the information identified in paragraph (b)(2) of the rule (discussed above) must be disclosed in an interactive data file that uses an XBRL format and the List of XBRL Tags for NRSROs as published on the Internet

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322 <u>See</u> Instructions for Exhibit 1 to Form NRSRO and proposed paragraph (b)(2)(vi)(E)(<u>1</u>) of Rule 17g-7.

323 <u>See</u> Instructions for Exhibit 1 to Form NRSRO and proposed paragraph (b)(2)(vi)(E)(<u>2</u>) of Rule 17g-7.

324 <u>See</u> Instructions for Exhibit 1 to Form NRSRO and proposed paragraph (b)(2)(vi)(E)(<u>3</u>) of Rule 17g-7.

325 <u>See</u> proposed new paragraph (b)(2)(vii) of Rule 17g-7.

website of the Commission.[326] This would be consistent with the current requirement of the 100% Rule.[327] As discussed above, however, the data fields that would need to have an XBRL tag would be expanded.[328]

Proposed paragraph (b)(4) of Rule 17g-7 would specify when a rating action would need to be disclosed by establishing two distinct grace periods: 12 months and 24 months.[329] In particular, a rating action would need to be disclosed: (1) within 12 months from the date the action is taken, if the credit rating subject to the action is issuer-paid;[330] (2) or within 24 months from the date the action is taken, if the credit rating subject to the action is not issuer-paid.[331] These separate grace periods for issuer-paid and non-issuer-paid credit ratings are consistent with the current requirement of the 100% Rule.[332]

Finally, paragraph (b)(5) of Rule 17g-7 would provide that an NRSRO may cease disclosing a rating history of an obligor, security, or money market instrument no earlier than 20 years after the date a rating action with respect to the obligor, security, or money market instrument is classified as a withdrawal of the credit rating pursuant to paragraph (b)(2)(v)(G) of Rule 17g-7, provided no subsequent credit ratings are assigned to the obligor, security, or money

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326 See proposed new paragraph (b)(3) of Rule 17g-7.

327 See 17 CFR 240.17g-2(d)(3)(ii).

328 See proposed new paragraph (b)(2)(i)-(vii).

329 See proposed new paragraph (b)(4) of Rule 17g-7.

330 See proposed paragraph (b)(4)(i) of Rule 17g-7.

331 See proposed paragraph (b)(4)(ii) of Rule 17g-7.

332 See 17 CFR 240.17g-2(d)(3)(i)(B) and (C). See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63837-63842 (Dec. 4, 2009) (discussing the 100% Rule and the reasons why the Commission adopted distinct 12 and 24 month grace periods).

market instrument after the withdrawal classification.[333] This proposed requirement is designed to ensure that information about credit ratings that are withdrawn for any reason would remain a part of the disclosure for a significant period of time. The Commission preliminarily believes this would address concerns that an NRSRO might withdraw a credit rating to remove its history from the disclosure requirement to, for example, make the performance of its credit ratings appear better than, in fact, is the case.

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (b) of Rule 17g-7. The Commission also seeks comment on the following:

1. Should the 10% Rule be retained? For example, could it be enhanced to meet the requirement of Section 15E(q)(A) of the Exchange Act that disclosures be comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs? If so, how could the 10% Rule be modified to better meet this requirement? Moreover, even with such modifications, would an enhanced 10% Rule provide information to investors and other users of credit ratings that would be useful to assess the performance of credit ratings across NRSROs?
2. Should the proposed rule require that the disclosure of the ratings history information under the proposed enhancements to the 100% Rule be made freely available in writing, when requested? If so, how should an NRSRO meet such a request? For example, would an NRSRO be required to mail a written copy of information in the XBRL data file to a party requesting the information? If so, would it be appropriate to permit the NRSRO to charge reasonable handling and postage fees? Would such a requirement to provide a

333 See proposed paragraph (b)(5) of Rule 17g-7.

written copy of the information in the XBRL data file be feasible? Are there other ways an NRSRO could make this disclosure freely available in writing?

3. If the rule required an NRSRO to provide a written copy of the information in the XBRL data file, when requested, under what circumstances would a party request this information in writing given that it would be freely available on an easily accessible portion of the NRSRO's corporate Internet website? Moreover, why would a party request the information in written form when downloading an electronic file in an XBRL format would make accessing and analyzing the information much more easy?
4. Should the rule require that an NRSRO publish quarterly, bi-annual, or annual copies of the rating histories and that these be made available when requested to implement the "in writing" provision in the statute?
5. What practical issues should the Commission consider in implementing the proposed enhancements to the 100% Rule? For example, would the variances in the procedures and methodologies NRSROs use to determine credit ratings raise practical issues in terms of classifying and disclosing the proposed required information about a credit rating action? In addition, would the variances in the meanings and definitions that NRSROs ascribe to the categories of credit ratings in their rating scales raise practical issues in terms of classifying and disclosing the proposed required information about a credit rating action? How could the proposal be modified to address any practical issues identified without undermining the goal of making the data more useful in terms of the amount of information provided, the ability to search and sort the information, and the ability to compare historical rating information across NRSROs?

6. How long would it take an NRSRO to implement the proposed requirements and begin making the proposed disclosures? What steps would an NRSRO need to take to implement the proposed requirements?
7. What practical issues should the Commission consider with respect to the proposed requirement to add histories for all credit ratings outstanding as of June 26, 2007 to the disclosure? How could the proposal be modified to address any practical issues identified without undermining the rule's goal of making the data more useful in terms of the amount of information provided, the ability to search and sort the information, and the ability to compare historical rating information across NRSROs?
8. What practical issues should the Commission consider with respect to the proposed new requirement to disclose the name and CIK number of the issuer of a rated security or money market instrument? How could the proposal be modified to address any practical issues identified without undermining the goal of making the data more useful in terms of the amount of information provided, the ability to search and sort the information, and the ability to compare historical rating information across NRSROs?
9. What practical issues should the Commission consider with respect to the proposed new requirement to disclose the type of rating action? For example, are the proposed classifications a comprehensive list of the types of rating actions taken by NRSROs? If not, identify and describe any other types of rating actions. Would the disclosure of this data be useful to investors and other users of credit ratings? How could the proposal be modified to address any practical issues identified without undermining the goal of making the data more useful in terms of the amount of information provided, the ability

to search and sort the information, and the ability to compare historical rating information across NRSROs?

10. With respect to the proposal to disclose the types of rating actions, are the three sub-classifications proposed for the withdrawal classification sufficient? For example, should the rule further refine the "withdrawal for other reasons" sub-classification to require disclosure of certain other reasons that a credit rating might be withdrawn such as the obligor or issuer ceased paying for the credit rating?

11. What practical issues should the Commission consider with respect to the proposed new requirement to disclose the class or subclass of the credit rating? For example, are the descriptions of the subclasses of credit ratings for structured finance products sufficiently clear to provide an NRSRO with guidance as to how such credit ratings should be classified? How could the descriptions be modified to make them clearer and provide better guidance?

12. Are the subclasses of credit ratings for structured finance products the most appropriate way to divide this class of credit ratings? For example, should the "other-ABS" subclass be separated into subclasses based on the assets underlying the ABS (i.e., auto loans, auto leases, floor plan financings, credit card receivables, student loans, consumer loans, equipment loans, or equipment leases)? In addition, are there other classes of structured finance products that should be identified?

13. Commenters are referred to the questions in Section II.M.4.a of this release with respect Items 6 and 7 of Form NRSRO and how certain types of obligors, securities, and money market instruments should be classified for purposes of providing approximate amounts of credit ratings outstanding in each class of credit rating for which an applicant is

seeking registration (Item 6) or an NRSRO is registered (Item 7)? In responding to those questions, commenters should consider how proposed classifications could be applied for the purposes of proposed new paragraph (b)(2)(vi) of Rule 17g-7.

14. Is 20 years the appropriate amount of time to require that the ratings history for a withdrawn credit rating remain part of the disclosure? Should the rule require these histories be retained for a lesser period of time, such as 10 or 15 years or a greater period of time, such as 25 or 30 years? If a different time period would be more appropriate, explain the rationale for such different time period.
15. Are the existing 12 and 24 month grace periods appropriate? Should the Commission consider adopting a single grace period, rather than the existing bifurcated approach?

### F. CREDIT RATING METHODOLOGIES

Section 932(a)(8) of the Dodd-Frank Act amends Section 15E of the Exchange Act to add new subsection (r).[334] Section 15E(r) of the Exchange Act provides that the Commission shall prescribe rules, for the protection of investors and in the public interest, with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by NRSROs that require each NRSRO to ensure a number of objectives.[335] The Commission preliminarily believes it would be appropriate to implement Section 15E(r) by proposing rules requiring an NRSRO to establish, maintain, enforce, and document policies and procedures that are reasonably designed to ensure the objectives identified in that section of the statute.[336] This approach would allow an NRSRO to establish policies and procedures that can be integrated with its procedures and methodologies for determining credit ratings, which vary across NRSROs. At

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334 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(r).

335 See 15 U.S.C. 78o-7(r)(1)-(3).

336 See id.

the same time, the proposed rule would set forth specific objectives that the policies and procedures would need to be reasonably designed to achieve both in design and operation. The Commission preliminarily believes this approach would be appropriate, particularly given that the objectives set forth in Section 15E(r) of the Exchange Act relate to the procedures and methodologies an NRSRO uses to determine credit ratings.[337]

For these reasons, the Commission is proposing to implement Section 15E(r) of the Exchange Act, in large part, through paragraph (a) of new Rule 17g-8.[338] The Commission also is proposing an amendment to Rule 17g-2 to apply the record retention and production requirements of that rule to the policies and procedures.[339]

#### 1. Proposed Paragraph (a) of New Rule 17g-8

As noted above, proposed paragraph (a) of new Rule 17g-8 would require an NRSRO to have policies and procedures that are reasonably designed to achieve objectives identified in Section 15E(r) of the Exchange Act.[340] In particular, the prefatory text would require an NRSRO to establish, maintain, enforce, and document policies and procedures that are reasonably designed to ensure the objectives identified in paragraphs (a)(1), (2), (3), (4), and (5).

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337 See Section 15E(r) of the Exchange Act (15 U.S.C. 78o-7(r)); see also Section 15E(c)(2) of the Exchange Act (providing, in pertinent part, that the Commission may not regulate the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings). 15 U.S.C. 78o-7(c)(2).

338 See proposed paragraph (a) of new Rule 17g-8. As discussed above in Section II.C of this release, the Commission is proposing to implement several provisions of the Dodd-Frank Act through rules that would prescribe policies and procedures an NRSRO would need to establish, maintain, enforce, and document. The Commission is proposing that all such rule requirements be consolidated in new Rule 17g-8. See proposed paragraphs (a), (b), and (c) of new Rule 17g-8 and Section II.C.1 of this release discussing proposed paragraph (c) and Section II.J.1 discussing proposed paragraph (b).

339 See proposed new paragraph (b)(13) of Rule 17g-2.

340 See prefatory text of proposed paragraph (a) of new Rule 17g-8.

Proposed paragraph (a)(1) of new Rule 17g-8 would implement Section 15E(r)(1)(A) of the Exchange Act.[341] This section provides that the Commission's rules shall require an NRSRO to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that are approved by the board of the NRSRO, or a body performing a function similar to that of a board.[342] The Commission preliminarily believes that the mandate set forth in the statute is explicit and, consequently, proposes rule text that would mirror the statutory text.[343] Therefore, proposed paragraph (a)(1) of new Rule 17g-8 would require an NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are approved by its board of directors or another body performing a function similar to that of a board of directors.[344] In this regard, the Commission notes that Section 15E(t)(3)(A) of the Exchange Act contains a self-executing provision that the board of the NRSRO shall oversee the "establishment, maintenance, and enforcement of the policies and procedures for determining credit ratings."[345] Consequently, the Commission preliminarily believes that the policies and procedures proposed to be required pursuant to paragraph (a)(1) of Rule 17g-8 would need to be designed to assist the NRSRO's board in carrying out this responsibility. In addition, Section 15E(t)(5) of the Exchange Act provides that the Commission may permit an NRSRO to delegate responsibilities required in Section 15E(t) to a committee if the Commission finds that compliance with the provisions of

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341 See proposed paragraph (a)(1) of new Rule 17g-8 and 15 U.S.C. 78o-7(r)(1)(A).

342 See 15 U.S.C. 78o-7(r)(1)(A).

343 See proposed paragraph (a)(1) of new Rule 17g-8.

344 Compare proposed paragraph (a)(1) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(1)(A).

345 See 15 U.S.C. 78o-7(t)(3)(A).

that section present an unreasonable burden on a small NRSRO.[346] Consequently, the Commission preliminarily believes that the policies and procedures proposed to be required pursuant to paragraph (a)(1) of Rule 17g-8 would need to be designed to assist the NRSRO's committee in carrying out the responsibility to oversee the "establishment, maintenance, and enforcement of the policies and procedures for determining credit ratings mandated by Section 15E(t)(3)(A) of the Exchange Act" if the committee (rather than the board) carries out this responsibilities.[347]

Proposed paragraph (a)(2) of new Rule 17g-8 would implement Section 15E(r)(1)(B) of the Exchange Act.[348] This section provides that the Commission's rules shall require an NRSRO to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that are in accordance with the policies and procedures of the NRSRO for the development and modification of credit rating procedures and methodologies.[349] The Commission preliminarily believes that the mandate set forth in the statute is explicit and, consequently, proposes rule text that would mirror the statutory text.[350] Therefore, proposed paragraph (a)(2) of new Rule 17g-8 would require an NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to

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346 See 15 U.S.C. 78o-7(t)(5).

347 See 15 U.S.C. 78o-7(t)(3)(A).

348 See proposed paragraph (a)(2) of new Rule 17g-8 and 15 U.S.C. 78o-7(r)(1)(B).

349 See 15 U.S.C. 78o-7(r)(1)(B).

350 See proposed paragraph (a)(2) of new Rule 17g-8.

determine credit ratings are developed and modified in accordance with the policies and procedures of the NRSRO.[351]

Proposed paragraph (a)(3)(i) of new Rule 17g-8 would implement Section 15E(r)(2)(A) of the Exchange Act.[352] This section provides that the Commission's rules shall require an NRSRO to ensure that when material changes are made to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models), the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply.[353] The Commission preliminarily believes that the mandate set forth in the statute is explicit and, consequently, proposes rule text that would mirror the statutory text.[354] Therefore, proposed paragraph (a)(3)(i) of new Rule 17g-8 would require an NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are applied consistently to all credit ratings to which the changed procedures or methodologies apply.[355]

Proposed paragraph (a)(3)(ii) of new Rule 17g-8 would implement Section 15E(r)(2)(B) of the Exchange Act.[356] This section provides that the Commission's rules shall require an NRSRO to ensure that when material changes are made to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models), to the extent that changes are made to credit rating surveillance procedures and methodologies, the changes

351 Compare proposed paragraph (a)(2) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(1)(B).

352 See proposed paragraph (a)(3)(i) of new Rule 17g-8 and 15 U.S.C. 78o-7(r)(2)(A).

353 See 15 U.S.C. 78o-7(r)(2)(A).

354 See proposed paragraph (a)(3)(i) of new Rule 17g-8.

355 Compare proposed paragraph (a)(3)(i) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(2)(A).

356 See proposed paragraph (a)(3)(i) of new Rule 17g-8 and 15 U.S.C. 78o-7(r)(2)(B).

are applied to then-current credit ratings by the NRSRO within a reasonable time period determined by the Commission, by rule.[357] The Commission proposes that paragraph (a)(3)(ii) of new Rule 17g-8 require the NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are, to the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to then-current credit ratings within a reasonable period of time taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated.[358] This proposed rule would mirror the text of Section 15E(r)(2)(B) of the Exchange Act but add additional language to implement the rulemaking provision that the changes are applied to then-current credit ratings by the NRSRO within a "reasonable time period determined by the Commission, by rule."[359]

In determining what time period would be reasonable, the Commission preliminarily believes that the NRSRO should be required to have policies and procedures designed to ensure that the changes are applied to existing credit ratings within a reasonable time period taking into consideration certain relevant factors; namely, the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated. The Commission preliminarily believes that a prescribed time frame (e.g., 1, 2, 3, 4 or more months) would not be appropriate because the

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357 15 U.S.C. 78o-7(r)(2)(B).

358 See proposed paragraph (a)(3)(ii) of new Rule 17g-8.

359 Compare proposed paragraph (a)(3)(ii) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(2)(B).

reasonableness of the timeframe in which existing credit ratings are modified would depend on the facts and circumstances. If the rule mandated a time-frame that is too short, under the circumstances, the NRSRO would need to rush to meet the deadline. This could negatively impact the quality of the credit ratings determined using the changed surveillance procedures and methodologies. Moreover, prescribing a timeframe that is too long could create an inadvertent "safe harbor" allowing the NRSRO to act more slowly to apply the changed surveillance procedures and methodologies to the impacted obligors, securities, and money market instruments. Consequently, the Commission preliminarily believes that the best approach is to require the NRSRO to apply the changed surveillance procedures and methodologies to the impacted obligors, securities, and money market instruments within a reasonable amount of time given the circumstances.

Proposed paragraph (a)(4)(i) of new Rule 17g-8 would implement Sections 15E(r)(2)(C), 15E(r)(3)(B), and 15E(r)(3)(D) of the Exchange Act as they all relate to disclosing information about material changes to procedures and methodologies (including changes to qualitative and quantitative data and models) an NRSRO uses to determine credit ratings.[360] Specifically, Section 15E(r)(2)(C) provides that the Commission's rules shall require an NRSRO to ensure that when material changes are made to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models), the NRSRO publicly discloses the reason for the change.[361] Section 15E(r)(3)(B) provides that the Commission's rules shall require an NRSRO to notify users of credit ratings when a material change is made to a

360 See proposed paragraph (a)(4)(i) of new Rule 17g-8, 15 U.S.C. 78o-7(r)(2)(B), 15 U.S.C. 78o-7(r)(3)(B), and 15 U.S.C. 78o-7(r)(3)(D).

361 See 15 U.S.C. 78o-7(r)(2)(C).

procedure or methodology, including to a qualitative model or quantitative input.[362] Finally, Section 15E(r)(3)(D) provides that that the Commission's rules shall require an NRSRO to notify users of credit ratings when a material change is made to a procedure or methodology, including to a qualitative model or quantitative input, of the likelihood the change will result in a change in current credit ratings.[363]

Consequently, Section 15E(r)(3)(B) requires the NRSRO to notify users of a change, Section 15E(r)(2)(C) requires the NRSRO to publish the reason for a change, and Section 15E(r)(3)(D) requires the NRSRO to disclose the potential impact of the change on existing credit ratings.[364] The Commission preliminarily believes that the mandates set forth in these sections are explicit and, consequently, proposes rule text that would mirror the statutory text.[365] Moreover, because the objective of the provision is to provide disclosure to investors and users of credit ratings, the Commission preliminarily believes proposed paragraph (a)(4)(i) of Rule 17g-8 should specify that these disclosures be published on an easily accessible portion of the NRSRO's corporate Internet website.[366] This would be consistent with the Commission's proposed Internet disclosure requirements for Form NRSRO under paragraph (i) of Rule 17g-1 and the ratings history information under proposed new paragraph (b)(1) of Rule 17g-1. For

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362 See 15 U.S.C. 78o-7(r)(3)(B).

363 See 15 U.S.C. 78o-7(r)(3)(D).

364 15 U.S.C. 78o-7(r)(3)(B), 15 U.S.C. 78o-7(r)(2)(C), and 15 U.S. C. 78o-7(r)(3)(D).

365 Compare proposed paragraph (a)(4)(ii) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(3)(B), 15 U.S.C. 78o-7(r)(2)(C), and 15 U.S. C. 78o-7(r)(3)(D).

366 As discussed above in Section II.E.1.b of this release, the Commission preliminarily believes there is no alternative means of disclosure that makes information as "readily accessible" as an Internet website. In addition, as discussed in that section of this release, the Commission preliminarily believes that information would be disclosed on an "easily accessible" portion of a corporate Internet website if it could be accessed through a clearly and prominently labeled hyperlink on the homepage of the NRSRO's corporate Internet website.

these reasons, proposed paragraph (a)(4)(i) of new Rule 17g-8 would require the NRSRO to have policies and procedures that are reasonably designed to ensure that the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the NRSRO uses to determine credit ratings, the reason for the changes, and the likelihood the changes will result in changes to any current ratings.[367]

Proposed paragraph (a)(4)(ii) of new Rule 17g-8 would implement Sections 15E(r)(3)(C) of the Exchange Act.[368] This section provides that the Commission's rules shall require an NRSRO to notify users of credit ratings when a significant error is identified in a procedure or methodology, including a qualitative or quantitative model, that may result in credit rating actions.[369] The Commission preliminarily believes that the mandate set forth in the statute is explicit and, consequently, proposes rule text that would mirror the statutory text.[370] Moreover, as with the proposed paragraph (a)(4)(i) disclosures, the Commission preliminarily believes proposed paragraph (a)(4)(ii) of Rule 17g-8 should specify that these disclosures be published on the NRSRO's corporate Internet website. Therefore, proposed paragraph (a)(4)(ii) of new Rule 17g-8 would require the NRSRO to have policies and procedures that are reasonably designed to ensure the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website significant errors identified in a procedure or methodology, including a qualitative or

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367 See proposed paragraph (a)(4)(i) of new Rule 17g-8.

368 See proposed paragraph (a)(4)(ii) of new Rule 17g-8 and 15 U.S. C. 78o-7(r)(3)(C).

369 See 15 U.S. C. 78o-7(r)(3)(C).

370 Compare proposed paragraph (a)(4)(ii) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(3)(C).

quantitative model, the NRSRO uses to determine credit ratings that may result in a change in current credit ratings.[371]

Proposed paragraph (a)(5) of new Rule 17g-8 would implement Section15E(r)(3)(A) of the Exchange Act.[372] This section provides that the Commission's rules shall require an NRSRO to notify users of credit ratings of the version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[373] The Commission preliminarily believes that the mandate set forth in the statute is explicit and, consequently, proposes rule text that would mirror the statutory text.[374] Therefore, proposed paragraph (a)(5) of new Rule 17g-8 would require the NRSRO to have policies and procedures that are reasonably designed to ensure that it discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[375]

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (a) of new Rule 17g-8. The Commission also seeks comment on the following:

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371 See proposed paragraph (a)(4)(ii) of new Rule 17g-8.

372 See proposed paragraph (a)(5) of new Rule 17g-8 and 15 U.S. C. 78o-7(r)(3)(A).

373 15 U.S.C. 78o-7(r)(3)(A).

374 Compare proposed paragraph (a)(5) of new Rule 17g-8, with 15 U.S.C. 78o-7(r)(3)(A).

375 See proposed paragraph (a)(5) of new Rule 17g-8. In addition, because this would be a rating-by-rating disclosure, the Commission is proposing, as discussed in Section II.G.3 of this release, that disclosure of the version of a credit rating procedure or methodology be part of the rule implementing Section 15E(s) of the Exchange Act, which specifies, among other things, that the Commission adopt rules requiring an NRSRO to generate a form to be included with the publication of a credit rating. See 15 U.S.C. 78o-7(s) and proposed new paragraph (a)(1)(ii)(B) of Rule 17g-7.

1. Are there alternatives to implementing Section 15E(r) of the Exchange Act (i.e., other than requiring policies and procedures reasonably designed to achieve the objectives identified in the statute) that the Commission should consider? If so, please identify those alternatives and explain how they would better achieve the goals of Section 15E(r)?
2. Would proposed paragraph (a)(1) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to achieve the objective that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are approved by its board of directors or another body performing a function similar to that of a board of directors appropriately meet the mandate identified in Section 15E(r)(1)(A) of the Exchange Act? If not, how could the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures?
3. Would proposed paragraph (a)(2) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are developed and modified in accordance with the policies and procedures of the NRSRO appropriately meet the mandate identified in Section 15E(r)(1)(B) of the Exchange Act? If not, how should the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures? In addition, how would this proposed requirement relate to the requirement in Section 15E(c)(3)(A) of the Exchange Act requiring an NRSRO to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings. For

example, would procedures established under proposed paragraph (a)(2) of Rule 17g-8 be part of the internal control structure or would they be designed to achieve different goals?

4. Would proposed paragraph (a)(3)(i) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are applied consistently to all credit ratings to which the changed procedures or methodologies apply appropriately meet the mandate identified in Section 15E(r)(2)(A) of the Exchange Act? If not, how should the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures?

5. Would proposed paragraph (a)(3)(ii) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are, to the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to then-current credit ratings within a reasonable period of time taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated appropriately meet the mandate identified in Section 15E(r)(2)(B) of the Exchange Act? If not, how should the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures?

6. With respect to proposed paragraph (a)(3)(ii) of new Rule 17g-8, should the Commission consider prescribing specific time frames such as 1, 2, 3, 4, 5, 6 or more months to apply

the new procedures and methodologies to existing credit ratings? Should the time frame depend on the methodology used to determine credit ratings (i.e., quantitative as opposed to qualitative)? As another alternative, should the Commission prescribe a timeframe based on the number of outstanding credit ratings? For example, should the Commission consider requiring that the new procedures and methodologies be applied to existing credit ratings in tranches such as 10 credit ratings per week or 60 credit ratings per month or some other ratio of the period of time to the number of credit ratings? Should such a ratio depend on the methodology used to determine credit ratings (i.e., quantitative as opposed to qualitative)?

7. Would proposed paragraph (a)(4)(i) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to ensure that the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the NRSRO uses to determine credit ratings, the reason for the changes, and the likelihood the changes will result in changes to any current ratings appropriately meet the mandates identified in Sections 15E(r)(3)(B), 15E(r)(2)(C) and 15E(r)(3)(D) of the Exchange Act? If not, how should the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures?
8. Would proposed paragraph (a)(4)(ii) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to ensure the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website significant errors identified in a procedure or methodology, including a qualitative or quantitative model, the NRSRO uses to determine credit ratings that may result in a change in current

credit ratings appropriately meet the mandates identified in Section 15E(r)(3)(C) of the Exchange Act? If not, how should the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures? For example, should the Commission define "significant error"? If so, how should the term be defined? Should the definition establish a materiality threshold? If so, how should such a threshold be prescribed? Similarly, should the Commission interpret the term "may result in a change in current credit ratings" to, for example, clarify the level of likelihood necessary to trigger the reporting requirement? For example, should there be a reasonable likelihood that the error may result in a change in current credit ratings?

9. Would proposed paragraph (a)(5) of new Rule 17g-8 requiring an NRSRO to have policies and procedures that are reasonably designed to ensure that it discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating appropriately meet the mandates identified in Sections 15E(r)(3)(A) of the Exchange Act? If not, how should the proposal be modified to provide more guidance to NRSROs about how to design their policies and procedures?

### 2. Proposed Amendment to Rule 17g-2

For the reasons discussed in Section II.A.2 of this release, the Commission preliminarily believes that the policies and procedures that would be required pursuant to proposed paragraph (a) of new Rule 17g-8 should be subject to the record retention and production requirements of Rule 17g-2.[376] Consequently, the Commission proposes adding new paragraph (b)(13) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain,

[376] 17 CFR 240.17g-2.

enforce, and document pursuant to proposed paragraph (a) of new Rule 17g-8 as a record that must be retained.[377]

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (a)(9) of Rule 17g-2.

### G. FORM AND CERTIFICATIONS TO ACCOMPANY CREDIT RATINGS

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new paragraph (s).[378] Sections 15E(s)(1) through (4), among other things, set forth provisions specifying Commission rulemaking with respect to disclosures an NRSRO must make with the publication of a credit rating.[379] The Commission proposes to implement these provisions by adding new paragraph (a) to Rule 17g-7.[380] As discussed in detail below, the prefatory text of proposed new paragraph (a) would require an NRSRO to publish two items when taking a rating action: (1) a form containing information about the credit rating resulting from or subject to the rating action;[381] and (2) any certification of a provider of third-party due

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377 See proposed new paragraph (b)(13) to Rule 17g-2; see also Section 17(a)(1) of the Exchange Act, which requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. 15 U.S.C. 78q(a)(1).

378 See 15 U.S.C. 78o-7(s).

379 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(s)(1)-(4). Section 15E(s)(4) of the Exchange Act also establishes requirements for issuers and underwriters of asset-backed securities, NRSROs, and providers of third-party due diligence services with respect to third-party due diligence services relating to asset-backed securities. See 15 U.S.C. 78o-7(s)(4)(A)-(D). The Commission's proposals to implement additional provisions in Section 15E(s)(4) are discussed below in Section II.H of this release.

380 See proposed new paragraph (a) of Rule 17g-7.

381 See proposed new paragraph (a)(1) of Rule 17g-7. As discussed below, this paragraph would implement, in large part, rulemaking specified in Sections 15E(s)(1), (2), and (3) of the Exchange Act. See 15 U.S.C. 78o-7(s)(1), (2), and (3).

diligence services received by the NRSRO that relates to the credit rating.[382] Proposed paragraph (a)(1) of Rule 17g-7 would contain three primary components: paragraph (a)(1)(i) prescribing the format of the form;[383] paragraph (a)(1)(ii) prescribing the content of the form;[384] and paragraph (a)(1)(iii) prescribing an attestation requirement for the form.[385] Proposed paragraph (a)(2) of Rule 17g-7 would identify the certification from a provider of third-party due diligence services as an item to be published with the rating action.[386]

### 1. Paragraph (a) – Prefatory Text

Section 15E(s)(1) of the Exchange Act provides that the Commission shall require, by rule, an NRSRO to prescribe a form to accompany the publication of each credit rating that discloses: (1) information relating to the assumptions underlying the credit rating procedures and methodologies; the data that was relied on to determine the credit rating; and if applicable, how the NRSRO used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating; and (2) information that can be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the

382 See proposed new paragraph (a)(2) of Rule 17g-7. As discussed below, this paragraph would implement, in part, rulemaking specified in Section 15E(s)(4) of the Exchange Act. See 15 U.S.C. 78o-7(s)(4).

383 See proposed new paragraph (a)(1)(i) of Rule 17g-7. As discussed below, this paragraph would implement, in large part, rulemaking specified in Section 15E(s)(2) of the Exchange Act. See 15 U.S.C. 78o-7(s)(2).

384 See proposed new paragraph (a)(1)(ii) of Rule 17g-7. As discussed below, this paragraph would implement, in large part, rulemaking specified in Section 15E(s)(3) of the Exchange Act. See 15 U.S.C. 78o-7(s)(3).

385 See proposed new paragraph (a)(1)(iii) of Rule 17g-7. As discussed below, this paragraph would implement, in large part, rulemaking specified in Section 15E(q)(2)(F) of the Exchange Act. See 15 U.S.C. 78o-7(q)(2)(F).

386 See proposed paragraph (a)(2) of Rule 17g-7.

NRSRO.[387] In addition, Section 15E(s)(2)(C) provides that the form shall be made readily available to users of credit ratings, in electronic or paper form, as the Commission may, by rule, determine.[388] Finally, Section 15E(s)(4)(D) of the Exchange Act provides that the Commission shall adopt rules requiring an NRSRO at the time it produces a credit rating, to disclose any certifications from providers of third-party due diligence services to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by the third-party.[389] The Commission proposes to implement Sections 15E(s)(1), 15E(s)(2)(C), and 15E(s)(4)(D) of the Exchange Act, in large part, through the prefatory text of proposed paragraph (a) of Rule 17g-7.[390]

The first sentence of the proposed prefatory text would provide that an NRSRO must publish the items described in paragraphs (a)(1) and (a)(2) of the proposed rule, as applicable, when taking a rating action with respect to credit rating assigned to an obligor, security, or money market instrument in a class of credit ratings for which the NRSRO is registered.[391] Proposed paragraph (a)(1) would identify the form and proposed paragraph (a)(2) would identify the certification from a provider of third-party due diligence services.[392] The Commission preliminarily intends that the requirement to publish the form and, when applicable, the certification would be triggered each time an NRSRO takes a rating action with respect to an

387 See 15 U.S.C. 78o-7(s)(1)(A) and (B).

388 See 15 U.S.C. 78o-7(s)(2)(C).

389 See 15 U.S.C. 78o-7(s)(4)(D).

390 See proposed new paragraph (a) of Rule 17g-7. As discussed below, the Commission proposes to implement Section 15E(s)(1)(A)(iii) of the Exchange Act – which relates to the use of servicer or remittance reports – in proposed paragraph (a)(1)(i)(G) of Rule 17g-7 because it specifies a particular item of information that would need to be disclosed in the form. See 15 U.S.C. 78o-7(a)(1)(i)(G).

391 See proposed new paragraph (a) of Rule 17g-7.

392 See proposed new paragraphs (a)(1) and (a)(2) of Rule 17g-7.

obligor, security, or money market instrument.[393] Consequently, the second sentence of the prefatory text of paragraph (a) would define the term "rating action" to mean any of the following: the publication of an expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating; an initial credit rating; an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default); a placement of an existing credit rating on credit watch or review; an affirmation of an existing credit rating; and a withdrawal of an existing credit rating. The inclusion of expected or preliminary credit ratings in the list of "rating actions" would incorporate the requirements in the note to current Rule 17g-7.[394] As the Commission explained when adopting Rule 17g-7, the definition of "credit rating" in the note is designed to address pre-sale reports, which are typically issued by an NRSRO with respect to an asset-backed security at the time the issuer commences the offering and typically include an expected or preliminary rating and a summary of the important features of a transaction.[395] Consequently, disclosure at the time of issuance of a pre-sale report is particularly important to investors, since such reports provide them with important information prior to the point at which they make an investment decision.[396] The Commission preliminarily believes that the importance of providing investors with timely information to enable them to make informed investment decisions applies equally to

393 In other words, the form and any certifications would need to be included when the NRSRO publishes an initial credit rating, publishes an upgrade of an existing credit rating, publishes a downgrade of an existing credit rating (including to a default category), publishes a credit rating as being on credit watch or review, publishes an affirmation of an existing credit rating, or withdraws a credit rating.

394 See Note to 17 CFR 240.17g-7, which provides that for the purposes of the rule's current requirements, a "credit rating" includes any expected or preliminary credit rating issued by an NRSRO.

395 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4503-4505 (Jan. 26, 2011).

396 Id.

the broader range of disclosures mandated by Section 15E(s) of the Exchange Act.[397] Accordingly, the Commission is proposing that the requirement to publish the form and any certifications be triggered upon the issuance of an expected or preliminary credit rating.[398] Furthermore, as the Commission stated when adopting Rule 17g-7, the term "preliminary credit rating" includes any credit rating, any range of ratings, or any other indications of a credit rating published prior to the assignment of an initial credit rating for a new issuance.[399]

The third sentence of the proposed prefatory text would provide that the items described in the form and any applicable certifications must be published in the same medium and made available to the same persons who can receive or access the credit rating that is the result of the rating action or the subject of rating action.[400] In other words, if the NRSRO publishes its credit ratings via a press release disseminated through its corporate Internet website and/or through other electronic information providers, the form and any applicable certifications would need to be disseminated through the same venues. The Commission preliminarily believes one way to accomplish this disclosure would be to publish the credit rating and information in the press release on the form along with the required contents of the form (discussed below) and, if

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397 15 U.S.C. 78o-7(s).

398 See proposed new paragraph (a) of Rule 17g-7.

399 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4503-4505 (Jan. 26, 2011).

400 See proposed new paragraph (a) of Rule 17g-7. A credit rating would be the "result" of a rating action in the case where the rating action is either the publication of an expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating; an initial credit rating; or an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default). A credit rating would be the "subject" of a rating action in the case where the rating action is either a placement of an existing credit rating on credit watch or review; an affirmation of an existing credit rating; or a withdrawal of an existing credit rating.

applicable, to attach any relevant certifications to the form.[401] In addition, the form and any certifications would need to be disseminated to the same persons who can receive or access the credit rating that is the result of the rating action or the subject of the rating action. Consequently, if the NRSRO publishes credit ratings for free on its corporate Internet website, it would need to make the form and any certifications similarly available. Alternatively, if the NRSRO operates under the subscriber-pay business model, it would need to disseminate the form and any certifications to the subscribers only.

Request for Comment

The Commission generally requests comment on all aspects of proposed prefatory text to paragraph (a) of Rule 17g-7. The Commission also seeks comment on the following:

1. What practical issues should the Commission consider in implementing the proposal that an NRSRO publish the form and the certifications every time the NRSRO takes a rating action? For example, should the certifications only be required to be included with the publication of an expected, preliminary, or initial credit rating or do they remain relevant for the term of the rated security or money market instrument and, therefore, should they continue to be published with subsequent rating actions? How could the proposal be modified to address any practical issues identified without undermining the goal of making this information available to users of the NRSRO's credit ratings?
2. What practical issues should the Commission consider in implementing the proposal that an NRSRO publish the form and the certifications in the same medium and make it

401 As discussed below, the Commission is proposing that the required contents of the form include the credit rating. Consequently, if adopted, an NRSRO would be required to include the credit rating on the form regardless of whether the NRSRO also publishes the credit rating on a separate record. If the NRSRO publishes the credit rating on a separate record, the NRSRO would be required to publish the form (which would also contain the credit rating) with the separate record under proposed new paragraph (a) of Rule 17g-7.

available to the same persons who can receive or access the credit rating resulting from or subject to the rating action? How could the proposal be modified to address any practical issues identified without undermining the goal of making this information available to users of the NRSRO's credit ratings?

3. What practical issues should the Commission consider in implementing the proposal to apply provisions of the current note to Rule 17g-7 – that the term "rating action" includes the publication of any expected or preliminary credit rating by the NRSRO – to all of the information required under Rule 17g-7 as it would be amended under these proposals? How could the proposal be modified to address any such practical issues without undermining the goal of the disclosure requirements currently contained in Rule 17g-7, that is, to make available to investors, if a credit rating is issued with respect to an asset-backed security, a description of: (1) the representations, warranties, and enforcement mechanisms available to investors; and (2) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities?
4. The Commission has proposed to require issuers of asset-backed securities using a registration statement on proposed Form SF-3 to file a preliminary prospectus, under proposed Rule 424(h), containing transaction-specific information at least 5 business days in advance of the first sale of securities in the offering in order to allow investors additional time to analyze the specific structure, assets, and contractual rights regarding each transaction.[402] Should the Commission explicitly require that the disclosures required by Rule 17g-7 be provided no later than the time of the proposed Rule 424(h) preliminary prospectus?

[402] See Asset Backed Securities, Securities Act Release No. 9117 (Apr. 7, 2010), 75 FR 23328 (May 3, 2010).

5. If the NRSRO publishes its credit ratings via a press release disseminated through its corporate Internet website and/or through other electronic information providers, would it be appropriate to permit the NRSRO to accomplish the required disclosure by publishing the credit rating and information in the press release on the form along with the required contents of the form (as discussed below) and, if applicable, attaching any relevant certifications to the form? What other methods could be used to make the required disclosures?

### 2. Paragraph (a)(1)(i) – Format of the Form

Proposed new paragraph (a)(1) of Rule 17g-7 would identify a form generated by the NRSRO that meets the requirements of proposed new paragraphs (a)(1)(i), (a)(1)(ii), and (a)(1)(iii) of Rule 17g-7 as the first item that must be included with a credit rating.[403] In this regard, Section 15E(s)(2) of the Exchange Act provides that the form developed by the NRSRO shall: (1) be easy to use and helpful for users of credit ratings to understand the information contained in the report;[404] (2) require the NRSRO to provide the required quantitative content specified in Section 15E(s)(3)(B) in a manner that is directly comparable across types of securities;[405] and (3) be made readily available to users of credit ratings, in electronic or paper form, as the Commission may, by rule, determine.[406] The Commission preliminarily believes that the provisions identified in items (1) and (2) above are high-level objectives that an NRSRO should be required to achieve in developing the presentation of the form. As discussed next,

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403 See proposed new paragraph (a)(1) of Rule 17g-7.

404 See 15 U.S.C. 78o-7(s)(2)(A).

405 See 15 U.S.C. 78o-7(s)(2)(B).

406 See 15 U.S.C. 78o-7(s)(2)(C). As discussed above, the Commission proposes to implement Section 15E(s)(2)(C) of the Exchange Act through the prefatory text in proposed new paragraph (a) of Rule 17g-7.

Section 15E(s)(3) of the Exchange Act identifies very specific items of information that the Commission's rule shall require an NRSRO to include in the form.[407] Given the specificity in Section 15E(s)(3), the Commission preliminarily believes it would be appropriate to use the higher level objectives specified in Section 15E(s)(2) to prescribe presentation requirements for the form.[408] Consequently, the Commission is proposing rule text that would mirror the statutory text.[409] In particular, proposed new paragraph (a)(1)(i)(A) of Rule 17g-7 would provide that the form generated by the NRSRO would need to be easy to use and helpful for users of credit ratings to understand the information contained in the form.[410] For example, the Commission preliminarily believes that a form that presents the required information in complex mathematical equations would not achieve this objective.

Similarly, proposed new paragraph (a)(1)(i)(B) of Rule 17g-7 would mirror the statutory text by requiring that the content described in proposed new paragraphs (a)(1)(ii)(K), (L) and (M) of Rule 17g-7 be disclosed in a manner that is directly comparable across types of obligors, securities, and money market instruments.[411] As discussed below, Section 15E(s)(3) of the

407 See 15 U.S.C. 78o-7(s)(3)(A) and (B).

408 See 15 U.S.C. 78o-7(s)(2) and 15 U.S.C. 78o-7(s)(3).

409 See proposed new paragraphs (a)(1)(i)(A) and (B) of Rule 17g-7.

410 Compare new paragraph (a)(1)(i)(A) of Rule 17g-7, with 15 U.S.C. 78o-7(s)(2)(A).

411 Compare new paragraph (a)(1)(i)(B) of Rule 17g-7, with 15 U.S.C. 78o-7(s)(2)(B). See also 15 U.S.C. 78o-7(s)(2)(B) and 15 U.S.C. 78o-7(s)(3)(B). While the statutory text only refers to "securities," Section 3(a)(60) of the Exchange Act defines the term "credit rating" to mean an "assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments." See 15 U.S.C. 78c(a)(60). The Commission believes it would be appropriate to expand this presentation requirement for the form to include credit ratings of "obligors" and "money market instruments" to ensure that it applies to all types of credit ratings and to be consistent with the Commission's existing and proposed rules for NRSROs, which commonly apply to credit ratings of "obligors, securities, and money market instruments." See, e.g., 17 CFR 240.17g-2 and 17 CFR 240.17g-3.

Exchange Act identifies qualitative and quantitative information that must be included in the form.[412] Section 15E(s)(2)(B) provides that the quantitative content identified in Section 15E(s)(3)(B) be directly comparable across types of securities.[413] The Commission is proposing that the quantitative content specified in Section 15E(s)(3)(B) of the Exchange Act be disclosed in the form pursuant to new paragraphs (a)(1)(ii)(K), (L), and (M) of Rule 17g-7.[414] Consequently, as proposed, new paragraph (a)(1)(i)(B) of Rule 17g-7 would implement Section 15E(s)(2)(B) by requiring an NRSRO to present this quantitative information in a manner that is directly comparable across types of obligors, securities, and money market instruments.

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (a)(1)(ii) of proposed Rule 17g-7. The Commission also seeks comment on the following:

1. Is the objective that the form be easy to use and helpful for users of credit ratings to understand the information contained in the report sufficiently clear to provide NRSROs with guidance on how to present the information in the form in accordance with this proposed requirement? If not, how should the proposal be modified to provide better guidance? Commenters should provide specific suggested rule text and explain the rationale for it.
2. Is the objective that the content described in proposed paragraphs (a)(1)(ii)(K), (L) and (M) of Rule 17g-7 be disclosed in a manner that is directly comparable across types of obligors, securities, and money market instruments sufficiently clear to provide NRSROs

412 See 15 U.S.C. 78o-7(s)(3).

413 See 15 U.S.C. 78o-7(s)(3)(A) and (B).

414 See proposed new paragraphs (a)(1)(ii)(K), (L), and (M) of Rule 17g-7 and 15 U.S.C. 78o-7(s)(3)(B)).

with guidance on how to present this information in the form in accordance with this proposed requirement? If not, how should the proposal be modified to provide better guidance? Commenters should provide specific suggested rule text and explain the rationale for it. In addition, how would adding "obligors" and "money market instruments" to the presentation requirement expand its scope? Finally, the Commission requests commenters to provide examples of disclosures in these areas that are being made now (if such disclosures are being made) and how the disclosures might be presented under the proposed requirements.

3. Should the Commission require that the information an NRSRO must include in the form be presented in a certain order to enhance comparability? For example, should the Commission require that the information be disclosed in the order in which it is identified in proposed paragraph (a)(1)(ii) of Rule 17g-7 discussed below? Are there other means of enhancing the comparability of forms among NRSROs? For example, should the Commission require a more standardized format for the form?

### 3. Paragraph (a)(1)(ii) – Content of the Form

Section 15E(s)(3) of the Exchange Act provides that the Commission shall require, by rule, that the form accompanying the publication of a credit rating contain specifically identified items of information.[415] In particular, Section 15E(s)(3)(A) identifies items of "qualitative content" and Section 15E(s)(3)(B) identifies items of "quantitative content."[416] The Commission preliminarily believes that the items of information identified in Sections 15E(s)(3)(A) and (B) are explicit and, consequently, proposes rule text that would mirror the statutory text.[417] In

415 See 15 U.S.C. 78o-7(s)(3).

416 See 15 U.S.C. 78o-7(s)(3)(A) and (B).

417 Compare proposed new paragraph (a)(1)(ii) of Rule 17g-7, with 15 U.S.C. 78o-7(s)(3).

addition, the Commission also is proposing that certain additional information be included in the form.

Prefatory Text of Paragraph (a)(1)(ii). The prefatory text of proposed new paragraph (a)(1)(ii) of Rule 17g-7 would provide that the form generated by the NRSRO must contain information about the credit rating identified in paragraphs (a)(1)(ii)(A) through (N).[418]

Paragraph (a)(1)(ii)(A). The first item of information would be identified in proposed new paragraph (a)(1)(ii)(A) of Rule 17g-7.[419] This paragraph would implement, in part, Section 15E(s)(3)(A)(i) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form the credit ratings produced by the NRSRO.[420] Specifically, paragraph (a)(1)(ii)(A) of Rule 17g-7 would require the NRSRO to include the symbol, number, or score in the rating scale used by the NRSRO to denote the credit rating categories and notches within categories assigned to the obligor, security, or money market instrument that is the subject of the rating action and the identity of the obligor, security, or money market instrument.[421] In other words, the form would need to identify the symbol, number, or score representing the notch in the applicable rating scale assigned to the obligor, security, or money market instrument, which, as proposed in the prefatory text to paragraph (a) of Rule 17g-7, would include a preliminary credit rating, an initial credit rating, an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default), a placement of an existing credit

418 See proposed new paragraph (a)(1)(ii) of Rule 17g-7.

419 See proposed new paragraph (a)(1)(ii)(A) of Rule 17g-7.

420 See 15 U.S.C. 78o-7(s)(3)(A)(i).

421 Id.

rating on watch or review, an affirmation of an existing credit rating, or withdrawal of an existing credit rating.[422]

In addition, under proposed new paragraph (a)(1)(ii)(A) of Rule 17g-7, the form would need to contain the identity of the obligor, security, or money market instrument that is the subject of the rating action. The Commission preliminarily believes that the identity of the obligor would be the person's legal name and any other name the obligor uses in its business. Furthermore, the Commission preliminarily believes that the identity of the security or money market instrument would be the name of the security or money market instrument, if applicable, and a description of the security or money market instrument. For example, a bond could be identified as "senior unsecured debt issued by Company XYZ maturing in 2015." Providing the CUSIP for the security or money market instrument also could be a way to further identify it. The Commission preliminarily believes that the disclosure on the form of the identity of the obligor, security, or money market instrument must be sufficient to notify (and not confuse) users of the form as to the identity of rated obligor, security, or money market instrument. As discussed above, the Commission is proposing in new paragraph (a)(1)(i)(A) of Rule 17g-7 that the NRSRO must generate a form that is easy to use and helpful for users of credit ratings to understand the information contained in the form.[423] The Commission preliminarily believes a form that does not clearly identify the obligor, security, or money market instrument subject to the rating action would not meet this requirement.

Paragraph (a)(1)(ii)(B). The second item of information would be identified in proposed new paragraph (a)(1)(ii)(B) of Rule 17g-7.[424] This paragraph would implement, in part, Section

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422 See proposed new paragraph (a) of Rule 17g-7.

423 See proposed new paragraph (a)(1)(i)(A) of Rule 17g-7.

424 See proposed new paragraph (a)(1)(ii)(B) of Rule 17g-7.

15E(r)(3)(A) of the Exchange Act.[425] As discussed above in Section II.F.1 of this release, Section 15E(r)(3)(A) provides that the rules adopted by the Commission must ensure an NRSRO notifies users of credit ratings of the version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[426] The Commission is proposing to implement Section 15E(r)(3)(A), in part, through paragraph (a)(5) of new Rule 17g-8.[427] Proposed paragraph (a)(5) of new Rule 17g-8 would require an NRSRO to have policies and procedures that are reasonably designed to ensure the NRSRO discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.

The Commission proposes to further implement Section 15E(r)(3)(A) of the Exchange Act through proposed paragraph (a)(1)(ii)(B) of Rule 17g-7. Specifically, paragraph (a)(1)(ii)(B) would require the NRSRO to disclose on the form the version of the procedure or methodology used to determine the credit rating.[428] The Commission preliminarily believes that this disclosure could be made by identifying the name of the procedure or methodology (including any number used to denote the version), the date the procedure was implemented, and an Internet URL where further information about the procedure or methodology can be obtained.[429] The Commission preliminarily believes that proposed paragraph (a)(1)(ii)(B) of Rule 17g-7 would complement and work in conjunction with proposed paragraph (a)(5) of new Rule 17g-8.[430]

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425 See 15 U.S.C. 78o-7(r)(3)(A).

426 Id.

427 See proposed paragraph (a)(5) of new Rule 17g-8.

428 See proposed paragraph (a)(1)(ii)(B) of Rule 17g-7.

429 For example, a disclosure could resemble: "RMBS Rating Methodology 3.0, implemented February 12, 2011. For further information go to [insert website address]."

430 See 15 U.S.C. 78o-7(r)(3)(A), proposed new paragraph (a)(1)(ii)(B) of Rule 17g-7, and

Rule 17g-7 would require the disclosure and Rule 17g-8 would require the NRSRO to have policies and procedures that are reasonably designed to ensure the disclosure is made.[431]

The Commission also notes that Section 15E(s)(1)(B) of the Exchange Act provides that the Commission shall require, by rule, each NRSRO to prescribe a form to accompany the publication of a credit rating that discloses information that can be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the NRSRO.[432] The Commission preliminarily believes that disclosing the version of the procedure or methodology used to determine the credit rating would promote this goal. For example, credit rating methodologies that are predominantly quantitative rely on models to produce credit ratings. These models periodically are updated and released as newer or different versions of the previous model. The Commission preliminarily believes disclosing the version of a model used to produce a credit rating would help investors and other users of credit ratings better understand the credit rating and how the determination of the credit rating may differ from similar products rated using an earlier version of the model.

Paragraph (a)(1)(ii)(C). The third item of information would be identified in proposed new paragraph (a)(1)(ii)(C) of Rule 17g-7.[433] This paragraph would implement Section 15E(s)(3)(A)(ii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form the main assumptions and principles used in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured

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proposed paragraph (a)(5) of Rule 17g-8.

431 See proposed new paragraph (a)(1)(ii)(B) of Rule 17g-7 and proposed paragraph (a)(5) of Rule 17g-8.

432 See 15 U.S.C. 78o-7(s)(1)(B).

433 See proposed new paragraph (a)(1)(ii)(C) of Rule 17g-7.

products.[434] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(C) of Rule 17g-7 would mirror the statutory text.[435] In particular, proposed new paragraph (a)(1)(ii)(C) of Rule 17g-7 would require the NRSRO to disclose in the form the main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating, including qualitative methodologies and quantitative inputs and, if the credit rating is for a structured finance product, assumptions about the correlation of defaults across the underlying assets.[436]

Paragraph (a)(1)(ii)(D). The fourth item of information would be identified in proposed new paragraph (a)(1)(ii)(D) of Rule 17g-7.[437] This paragraph would implement Section 15E(s)(3)(A)(iii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form the potential limitations of the credit ratings and the types of risks excluded from the credit ratings that the NRSRO does not comment on, including liquidity, market, and other risks.[438] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(D) of Rule 17g-7 would mirror the statutory text.[439] In particular, proposed new paragraph (a)(1)(ii)(D) of Rule 17g-7 would require the NRSRO to disclose in the form the potential limitations of the credit rating, including the types of risks excluded from the credit

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434 See 15 U.S.C. 78o-7(s)(3)(A)(ii).

435 Compare 15 U.S.C. 78o-7(s)(3)(A)(ii), with proposed new paragraph (a)(1)(ii)(C) of Rule 17g-7.

436 See proposed new paragraph (a)(1)(ii)(C) of Rule 17g-7.

437 See proposed new paragraph (a)(1)(ii)(D) of Rule 17g-7.

438 See 15 U.S.C. 78o-7(s)(3)(A)(iii).

439 Compare 15 U.S.C. 78o-7(s)(3)(A)(iii), with proposed new paragraph (a)(1)(ii)(D) of Rule 17g-7.

rating that the NRSRO does not comment on, including, as applicable, liquidity, market, and other risks.[440]

Paragraph (a)(1)(ii)(E). The fifth item of information would be identified in proposed new paragraph (a)(1)(ii)(E) of Rule 17g-7.[441] This paragraph would implement Section 15E(s)(3)(A)(iv) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form information on the uncertainty of the credit rating, including: (1) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and (2) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including any limits on the scope of historical data; and any limits in accessibility to certain documents or other types of information that would have better informed the credit rating.[442] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(E) of Rule 17g-7 would mirror the statutory text.[443] In particular, proposed new paragraph (a)(1)(ii)(E) of Rule 17g-7 would require the NRSRO to disclose in the form information on the uncertainty of the credit rating, including: (1) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and (2) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including: any limits on the scope of historical data; and any

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440 See proposed new paragraph (a)(1)(ii)(D) of Rule 17g-7.

441 See proposed new paragraph (a)(1)(ii)(E) of Rule 17g-7.

442 See 15 U.S.C. 78o-7(s)(3)(A)(iv).

443 Compare 15 U.S.C. 78o-7(s)(3)(A)(iv), with proposed new paragraph (a)(1)(ii)(E) of Rule 17g-7.

limits in accessibility to certain documents or other types of information that would have better informed the credit rating.[444]

Paragraph (a)(1)(ii)(F). The sixth item of information would be identified in proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7.[445] This paragraph would implement Section 15E(s)(3)(A)(v) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form whether and to what extent third-party due diligence services have been used by the NRSRO, a description of the information that such third-party reviewed in conducting due diligence services, and a description of the findings and conclusions of such third-party.[446] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7 would mirror the statutory text.[447] In particular, proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7 would require the NRSRO to disclose in the form whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information that such third-party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third-party.[448]

The Commission notes that Section 15E(s)(4)(A) of the Exchange Act contains a requirement that the issuer or underwriter of any asset-backed security shall make publicly available the findings and conclusions of any third-party due diligence report obtained by the

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444 See proposed new paragraph (a)(1)(ii)(E) of Rule 17g-7.

445 See proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7.

446 See 15 U.S.C. 78o-7(s)(3)(A)(v).

447 Compare 15 U.S.C. 78o-7(s)(3)(A)(v), with proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7.

448 See proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7.

issuer or underwriter.[449] In addition, Section 15E(s)(4)(B) of the Exchange Act contains a self-executing requirement providing that in any case in which third-party due diligence services are employed by an NRSRO, an issuer, or an underwriter, the person providing the due diligence services shall provide to any NRSRO that produces a rating to which such services relate, written certification in a format prescribed, by rule, by the Commission.[450] Finally, as discussed above in Section II.G.1 of this release and below in Section II.G.5, the NRSRO would be required to disclose with the publication of a credit rating any certifications it receives from a provider of third-party due diligence services pursuant to Section 15E(s)(4)(B) of the Exchange Act.[451] The Commission preliminarily believes that the disclosure that would be required pursuant to proposed paragraph (a)(1)(ii)(F) of Rule 17g-7 would need to describe how the NRSRO used the findings and conclusions of any third-party due diligence report made publicly available by an issuer or underwriter pursuant to Section 15E(s)(4)(A) of the Exchange Act.[452] Similarly, the Commission preliminarily believes that the disclosure would need to describe how the NRSRO used any certifications it receives from providers of third-party due diligence services pursuant to Section 15E(s)(4)(B) of the Exchange Act.[453]

Paragraph (a)(1)(ii)(G). The seventh item of information would be identified in proposed new paragraph (a)(1)(ii)(G) of Rule 17g-7.[454] This paragraph would implement Section

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449 See 15 U.S.C. 78o-7(s)(4)(A). The Commission's proposals for implementing this provision are discussed below in Section II.H.1 of this release.

450 See 15 U.S.C. 78o-7(s)(4)(B). The Commission's proposals for implementing this provision are discussed below in Sections II.H.2 and II.H.3 of this release.

451 See proposed prefatory text of paragraph (a) and proposed paragraph (a)(2) of Rule 17g-7.

452 See 15 U.S.C. 78o-7(s)(4)(A).

453 See 15 U.S.C. 78o-7(s)(4)(B).

454 See proposed new paragraph (a)(1)(ii)(G) of Rule 17g-7.

15E(s)(1)(A)(iii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose, if applicable, how the NRSRO used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating.[455] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(G) of Rule 17g-7 would mirror the statutory text.[456] In particular, proposed new paragraph (a)(1)(ii)(G) of Rule 17g-7 would require the NRSRO to disclose in the form, if applicable, how servicer or remittance reports were used, and with what frequency, to conduct surveillance of the credit rating.[457]

Paragraph (a)(1)(ii)(H). The eighth item of information would be identified in proposed new paragraph (a)(1)(ii)(H) of Rule 17g-7.[458] This paragraph would implement Section 15E(s)(3)(A)(vi) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form a description of the data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating.[459] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(H) of Rule 17g-7 would mirror the statutory text.[460] In particular, proposed new paragraph (a)(1)(ii)(H) of Rule 17g-7 would require the NRSRO to disclose in the form a description of the data about any

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455 See 15 U.S.C. 78o-7(s)(1)(A)(iii).

456 Compare 15 U.S.C. 78o-7(s)(1)(A)(iii), with proposed new paragraph (a)(1)(ii)(G) of Rule 17g-7.

457 See proposed new paragraph (a)(1)(ii)(G) of Rule 17g-7.

458 See proposed new paragraph (a)(1)(ii)(H) of Rule 17g-7.

459 See 15 U.S.C. 78o-7(s)(3)(A)(vi).

460 Compare 15 U.S.C. 78o-7(s)(3)(A)(vi), with proposed new paragraph (a)(1)(ii)(H) of Rule 17g-7.

obligor, issuer, security, or money market instrument that was relied upon for the purpose of determining the credit rating.[461]

Paragraph (a)(1)(ii)(I). The ninth item of information would be identified in proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7.[462] This paragraph would implement Section 15E(s)(3)(A)(vii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form a statement containing an overall assessment of the quality of information available and considered in producing a rating for the obligor, security, or money market instrument, in relation to the quality of information available to the NRSRO in rating similar obligors, securities, and money market instruments.[463] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently, proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7 would mirror the statutory text.[464] In particular, proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7 would require the NRSRO to disclose in the form a statement containing an overall assessment of the quality of information available and considered in producing a rating for an obligor, security, or money

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461 See proposed new paragraph (a)(1)(ii)(H) of Rule 17g-7.

462 See proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7.

463 See 15 U.S.C. 78o-7(s)(3)(A)(vii). The Commission notes that the end of the statutory text refers to ratings of "similar issuances." Id. However, the preceding text refers to rating an "obligor, security, or money market instrument." Id. As discussed earlier, a credit rating of an "obligor" commonly means the rating of the obligor as an entity rather than a rating of securities or money market instruments issued by the obligor. Consequently, the rating of an obligor may not relate to an "issuance" of a particular security or money market instrument. Therefore, the Commission proposes in new paragraph (a)(1)(ii)(I) of Rule 17g-7 to use the term "similar obligors, securities, or money market instruments" instead of the term "similar issuances" in the statutory text.

464 Compare 15 U.S.C. 78o-7(s)(3)(A)(vii), with proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7.

market instrument, in relation to the quality of information available to the NRSRO in rating similar obligors, securities, or money market instruments.[465]

Paragraph (a)(1)(ii)(J). The tenth item of information would be identified in proposed new paragraph (a)(1)(ii)(J) of Rule 17g-7.[466] This paragraph would implement, in part, Section 15E(s)(3)(A)(viii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form information relating to conflicts of interest of the NRSRO.[467] The Commission preliminarily believes that the statutory text of Section 15E(s)(3)(A)(viii) is relatively general in that it does not specify the type of information about conflicts of interest that should be disclosed.[468] Accordingly, the Commission is proposing to identify three specific items of information that, at a minimum, would need to be disclosed about conflicts of interest.[469]

The first type of disclosure would be identified in proposed new paragraph (a)(1)(ii)(J)(1) of Rule 17g-7, which would require the NRSRO to classify the credit rating as either "solicited" or "unsolicited."[470] Proposed new paragraphs (a)(1)(ii)(J)(1)(i), (ii) and (iii) of Rule 17g-7 would define "solicited" and "unsolicited" credit ratings.[471] In this regard, the Commission is proposing two different sub-categories for solicited ratings: "solicited sell-side" and "solicited buy-side."[472] Proposed new paragraph (a)(1)(ii)(J)(1)(i) of Rule 17g-7 would define "Solicited

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465 See proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7.

466 See proposed new paragraph (a)(1)(ii)(I) of Rule 17g-7.

467 See 15 U.S.C. 78o-7(s)(3)(A)(viii).

468 Id.

469 See proposed new paragraph (a)(1)(ii)(J) of Rule 17g-7.

470 See proposed new paragraph (a)(1)(ii)(J)(1) of Rule 17g-7.

471 See proposed new paragraphs (a)(1)(ii)(J)(1)(i), (ii) and (iii) of Rule 17g-7.

472 See proposed new paragraph (a)(1)(ii)(J)(1)(i) and (ii) of Rule 17g-7.

sell-side" to mean the credit rating was paid for by the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated.[473] In other words, the "solicited sell-side" classification would be used for issuer-paid credit ratings. Proposed new paragraph (a)(1)(ii)(J)(1)(ii) of Rule 17g-7 would define "Solicited buy-side" to mean the credit rating was paid for by a person other than the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated. For example, a potential investor in a security may pay an NRSRO to determine a credit rating for the security. The Commission preliminarily believes this distinction is relevant because, depending on the type of entity paying for the rating, the potential conflict may exert different types of undue influence on the NRSRO. For example, a sell-side purchaser of the credit rating presumably would want the highest rating possible. However, a buy-side purchaser could want a lower credit rating if the purchaser is maintaining a short position or desiring a higher interest rate.

Proposed new paragraph (a)(1)(ii)(J)(1)(iii) of Rule 17g-7 would define an "unsolicited" credit rating to mean a credit rating the NRSRO was not paid to determine.[474] The Commission preliminarily intends this definition to include credit ratings funded by selling subscriptions to access the credit ratings (so-called "subscriber-paid credit ratings"). However, if a subscriber paid the NRSRO to determine a credit rating for a specific obligor, security, or money market instrument, the credit rating would need to be classified as either "solicited sell-side" if the subscriber also was the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated, or "solicited buy-side" if the subscriber was not the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or

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473 See proposed new paragraph (a)(1)(ii)(J)(1)(i) of Rule 17g-7.

474 See proposed new paragraph (a)(1)(ii)(J)(1)(iii) of Rule 17g-7.

money market instrument being rated. This would apply, for example, if the subscriber was an investor or potential investor in the security or money market instrument and hired the NRSRO to specifically rate the security or money market instrument. In such a case, the credit rating would need to be classified as "solicited buy-side."

The second type of conflict disclosure would be identified in proposed new paragraph (a)(1)(ii)(J)(2) of Rule 17g-7.[475] This paragraph would provide that if the credit rating is classified as either "solicited sell-side" or "solicited buy-side" the NRSRO would be required to disclose whether the NRSRO provided services other than determining credit ratings to the person that paid for the rating during the most recently ended fiscal year.[476] In other words, the NRSRO would be required to indicate whether the person who purchased the credit rating was a client with respect to other services provided by the NRSRO. The Commission preliminarily believes clients paying an NRSRO for services in addition to determining credit ratings may pose an increased risk of exerting undue influence on the NRSRO with respect to its determination of credit ratings.[477] The Commission has adopted rules that address consulting and advisory services under authority in Section 15E(h)(2)(B).[478] The Commission preliminarily believes that the proposed disclosure requirement about other services would complement these requirements.

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475 See proposed new paragraph (a)(1)(ii)(J)(2) of Rule 17g-7.

476 Id.

477 In this regard, the Commission notes that Section 939H of the Dodd-Frank Act contains a sense of the Congress that the Commission should exercise rulemaking authority under Section 15E(h)(2)(B) of the Exchange Act to prevent improper conflicts of interest arising from employees of NRSROs providing services to issuers of securities that are unrelated to the issuance of credit ratings, including consulting, advisory, and other services. See Pub. L. No. 111-203 § 939H.

478 See 17 CFR 240.17g-5(a) and (b)(3), (4) and (5) and 17 CFR 240.17g-5(c).

The third type of conflict disclosure would be identified in proposed new paragraph (a)(1)(ii)(J)(3) of Rule 17g-7.[479] This paragraph would require disclosure of information about a conflict of interest influencing a credit rating action discovered as a result of a look-back review conducted pursuant to Section 15E(h)(4)(A) of the Exchange Act and proposed paragraph (c) of new Rule 17g-8.[480]

Paragraph (a)(1)(ii)(K). The eleventh item of information would be identified in proposed new paragraph (a)(1)(ii)(K) of Rule 17g-7.[481] This paragraph would implement Section 15E(s)(3)(B)(i) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form an explanation or measure of the potential volatility of the credit rating, including: (1) any factors that might lead to a change in the credit ratings; and (2) the magnitude of the change that a user can expect under different market conditions.[482] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(K) of Rule 17g-7 would mirror the statutory text.[483] In particular, proposed new paragraph (a)(1)(ii)(K) of Rule 17g-7 would require the NRSRO to disclose in the form an explanation or measure of the potential volatility of the credit rating, including: (1) any factors that might lead to a change in the credit rating; and (2) the magnitude of the change that could occur under different market conditions.[484]

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479 See proposed new paragraph (a)(1)(ii)(J)(3) of Rule 17g-7.

480 This information is discussed in detail above in Section II.C.1 of this release.

481 See proposed new paragraph (a)(1)(ii)(K) of Rule 17g-7.

482 See 15 U.S.C. 78o-7(s)(3)(B)(i).

483 Compare 15 U.S.C. 78o-7(s)(3)(B)(i), with proposed new paragraph (a)(1)(ii)(K) of Rule 17g-7.

484 See proposed new paragraph (a)(1)(ii)(K) of Rule 17g-7.

Paragraph (a)(1)(ii)(L). The twelfth item of information would be identified in proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7.[485] This paragraph would implement Section 15E(s)(3)(B)(ii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form information on the content of the credit rating, including: (1) the historical performance of the credit rating; and (2) the expected probability of default and the expected loss in the event of default.[486] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7 would mirror the statutory text.[487] In particular, proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7 would require the NRSRO to disclose in the form information on the content of the rating, including: (1) if applicable, the historical performance of the rating; and (2) the expected probability of default and the expected loss in the event of default.[488]

Paragraph (a)(1)(ii)(M). The thirteenth item of information would be identified in proposed new paragraph (a)(1)(ii)(M) of Rule 17g-7.[489] This paragraph would implement Section 15E(s)(3)(B)(iii) of the Exchange Act, which provides that the Commission's rule shall require the NRSRO to disclose in the form information on the sensitivity of the credit rating to assumptions made by the NRSRO, including: (1) five assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and (2) an analysis, using specific examples, of

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485 See proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7.

486 See 15 U.S.C. 78o-7(s)(3)(B)(ii).

487 Compare 15 U.S.C. 78o-7(s)(3)(B)(ii), with proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7.

488 See proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7.

489 See proposed new paragraph (a)(1)(ii)(M) of Rule 17g-7.

how each of the 5 assumptions identified impacts a credit rating.[490] The Commission preliminarily believes that the statutory text is explicit with respect to the information to be disclosed and, consequently proposed new paragraph (a)(1)(ii)(M) of Rule 17g-7 would mirror the statutory text.[491] In particular, proposed new paragraph (a)(1)(ii)(M) of Rule 17g-7 would require the NRSRO to disclose in the form information on the sensitivity of the rating to assumptions made by the NRSRO, including: (1) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and (2) an analysis, using specific examples, of how each of the 5 assumptions identified in the form impacts a rating.[492]

Paragraph (a)(1)(ii)(N). Finally, the fourteenth item of information would be identified in proposed new paragraph (a)(1)(ii)(N) of Rule 17g-7.[493] This paragraph would contain the current disclosure requirement in Rule 17g-7.[494] In particular, the current requirements in paragraphs (a) and (b) of Rule 17g-7 would be contained in proposed new paragraph (a)(1)(ii)(N).[495] Specifically, this paragraph would provide that if the credit rating is issued with respect to an asset-backed security, as that term is defined in Section 3(a)(77) of the Exchange Act, the NRSRO must include in the form a description of: (1) the representations, warranties,

490 See 15 U.S.C. 78o-7(s)(3)(B)(iii).

491 Compare 15 U.S.C. 78o-7(s)(3)(B)(iii), with proposed new paragraph (a)(1)(ii)(M) of Rule 17g-7.

492 See proposed new paragraph (a)(1)(ii)(M) of Rule 17g-7.

493 See proposed new paragraph (a)(1)(ii)(N) of Rule 17g-7.

494 See 17 CFR 240.17g-7. As discussed above Section II.G.1 of this release, the definition of "credit rating" in the third sentence of the prefatory text to proposed new paragraph (a) of Rule 17g-7 would contain the provisions in the current Note to 17 CFR 240.17g-7, which provides that for the purposes of the rule's current requirements, a "credit rating" includes any expected or preliminary credit rating issued by an NRSRO.

495 Compare 17 CFR 240.17g-7(a) and (b), with proposed new paragraph (a)(1)(ii)(N) of Rule 17g-7.

and enforcement mechanisms available to investors; and (2) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities.

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (a)(1)(ii) of proposed Rule 17g-7. The Commission also seeks comment on the following:

1. With respect to proposed paragraph (a)(1)(ii)(A), should the Commission consider requiring the disclosure of information in addition to the identity of the obligor's legal name and any other name that the obligor uses in its business? Are there additional or alternative ways to identify the obligor? Also, provide examples of how this disclosure might appear on the form.
2. With respect to proposed paragraph (a)(1)(ii)(A), should the Commission consider requiring the disclosure of information in addition to the name of the security or money market instrument, if applicable, and a description of the security or money market instrument? Are there additional or alternative ways to identify the security or money market instrument? Would disclosing the CUSIP alone be sufficient to identify the security or money market instrument? If so, should the Commission consider requiring that the CUSIP be disclosed? Also, provide examples of how this disclosure might appear on the form.
3. With respect to proposed paragraph (a)(1)(ii)(B), would the disclosure of the version of the procedure or methodology used to determine the credit rating in conjunction with proposed paragraph (a)(5) of Rule 17g-8 achieve the goals of Section 15E(r)(3)(A) of the Exchange Act? If not, what alternative or additional requirements should the

Commission consider? Also, provide examples of how this disclosure might appear on the form.

4. Proposed paragraph (a)(1)(ii)(C) of Rule 17g-7 would require an NRSRO to disclose in the form the main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating, including qualitative methodologies and quantitative inputs and, if the credit rating is for a structured finance product, assumptions about the correlation of defaults across the underlying assets. Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form. In addition, would the proposal require the disclosure of proprietary information? If so, what type or types of proprietary information would be disclosed? How could this issue be addressed?
5. Proposed paragraph (a)(1)(ii)(D) of Rule 17g-7 would require the NRSRO to disclose in the form the potential limitations of the credit rating, including the types of risks excluded from the credit rating that the NRSRO does not comment on, including, as applicable, liquidity, market, and other risks. Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form.
6. Proposed paragraph (a)(1)(ii)(E) of Rule 17g-7 require the NRSRO to disclose in the form information on the uncertainty of the credit rating, including: (1) information on the

reliability, accuracy, and quality of the data relied on in determining the credit rating; and (2) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including: any limits on the scope of historical data; and any limits in accessibility to certain documents or other types of information that would have better informed the credit rating. Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form. In addition, would the proposal require the disclosure of proprietary information? If so, what type or types of proprietary information would be disclosed? How could this issue be addressed?

7. Proposed paragraph (a)(1)(ii)(F) of Rule 17g-7 would require the NRSRO to disclose in the form whether and to what extent third-party due diligence services were used by NRSRO organization, a description of the information that such third-party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third-party? Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form.

8. With respect to proposed paragraph (a)(1)(ii)(F) of Rule 17g-7, how should the findings and conclusions of any third-party due diligence report made publicly available by the issuer or underwriter pursuant to Section 15E(s)(4)(A) of the Exchange Act be incorporated into the disclosure if used by the NRSRO? Similarly, how should any

certifications the NRSRO receives from providers of third-party due diligence services pursuant to Section 15E(s)(4)(B) of the Exchange Act be incorporated into the disclosure if used by the NRSRO? Also, provide examples of how this disclosure might appear on the form.

9. Proposed paragraph (a)(1)(ii)(G) of Rule 17g-7 would require the NRSRO to disclose in the form, if applicable, how servicer or remittance reports were used, and with what frequency, to conduct surveillance of the credit rating? Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form.

10. Proposed paragraph (a)(1)(ii)(H) of Rule 17g-7 would require the NRSRO to disclose in the form a description of the data about any obligor, issuer, security, or money market instrument that was relied upon for the purpose of determining the credit rating? Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form.

11. Proposed paragraph (a)(1)(ii)(I) of Rule 17g-7 would require the NRSRO to disclose in the form a statement containing an overall assessment of the quality of information available and considered in producing a rating for an obligor, security, or money market instrument, in relation to the quality of information available to the NRSRO in rating similar obligors, securities, or money market instruments. Is this proposed requirement

sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form.

12. With respect to proposed paragraph (a)(1)(ii)(J)(1) of Rule 17g-7, are the proposed definitions of "solicited sell-side", "solicited buy-side", and "unsolicited" credit ratings sufficiently clear? If not, how should the definitions be augmented or altered? Also, provide examples of how this disclosure might appear on the form.
13. With respect to proposed paragraph (a)(1)(ii)(J)(1) of Rule 17g-7, would distinguishing between "solicited sell-side" and "solicited buy-side" credit ratings provide useful disclosure of potentially different conflicts of interest? Alternatively, should the disclosure more simply require classification of whether the credit rating was "solicited" or "unsolicited"? Also, provide examples of how this disclosure might appear on the form.
14. With respect to proposed paragraph (a)(1)(ii)(J)(2) of Rule 17g-7, would the proposed disclosure of whether the NRSRO provided other services to the person that paid for the credit rating during the most recently ended fiscal year provide useful disclosure of potential conflicts of interest? Also, provide examples of how this disclosure might appear on the form.
15. With respect to proposed paragraph (a)(1)(ii)(J) of Rule 17g-7, is there other information about conflicts of interest that the Commission should consider requiring to be disclosed in the form? Commenters should provide specific examples of such information and

explain how it would provide useful information. Also, provide examples of how this disclosure might appear on the form.

16. Proposed paragraph (a)(1)(ii)(K) of Rule 17g-7 would require the NRSRO to disclose in the form an explanation or measure of the potential volatility of the credit rating, including: (1) any factors that might lead to a change in the credit rating; and (2) the magnitude of the change that could occur under different market conditions. Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form. Should the Commission provide guidance on the types of factors that should be disclosed to establish a materiality threshold? If so, describe the factors and the corresponding materiality threshold. Furthermore, should the Commission define the term "might lead to a change in the credit rating" to establish the level of probability necessary to trigger the disclosure? If so, how should the term be defined?

17. Proposed paragraph (a)(1)(ii)(L) of Rule 17g-7 would require the NRSRO to disclose in the form information on the content of the rating, including: (1) if applicable, the historical performance of the rating; and (2) the expected probability of default and the expected loss in the event of default. Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form.

18. With respect to proposed paragraph (a)(1)(ii)(M) of Rule 17g-7 would require the NRSRO to disclose in the form information on the sensitivity of the rating to assumptions made by the NRSRO, including: (1) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and (2) an analysis, using specific examples, of how each of the 5 assumptions identified in the form impacts a rating? Is this proposed requirement sufficiently explicit with respect to the information that would need to be disclosed? If not, what additional detail should the Commission provide in terms of the information that would need to be disclosed? Also, provide examples of how this disclosure might appear on the form. In addition, would the proposal require the disclosure of proprietary information? If so, what type or types of proprietary information would be affected? How could this issue be addressed?

19. Is the proposal to codify the current requirements in paragraphs (a) and (b) of Rule 17g-7 in proposed paragraph (a)(1)(ii)(N) of Rule 17g-7 appropriate? For example, would this re-designation change those requirements in some manner?

#### 4. Paragraph (a)(1)(iii) – Attestation Requirement

Section 15E(q)(2)(F) of the Exchange Act provides that the Commission's rules must require an NRSRO to include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.[496] While Section 15E(q) relates to disclosure of information about the performance of credit ratings, the Commission preliminarily believes this

[496] See 15 U.S.C. 78o-7(q)(2)(F).

attestation provision would more appropriately be implemented with respect to disclosures that must be made when a specific rating action is published. Consequently, the Commission proposes that it be part of the form that would be required to accompany a credit rating pursuant to rulemaking under Section 15E(s) of the Exchange Act as opposed to a part of the proposed disclosures of Transition/Default Matrices in Exhibit 1 to Form NRSRO or credit rating histories that would implement Section 15E(q).[497]

Consequently, the Commission proposes to implement this attestation requirement as part of the rule requirement for an NRSRO to generate a form to accompany the publication of a credit rating.[498] In particular, under the proposal, the NRSRO would be required to attach to the form a signed statement by a person within the NRSRO stating that the person has responsibility for the credit rating and, to the best knowledge of the person: (1) no part of the credit rating was influenced by any other business activities; (2) the credit rating was based solely upon the merits of the obligor, security, or money market instrument being rated; and (3) the credit rating was an independent evaluation of the risks and merits of the obligor, security, or money market instrument.[499] Thus, the proposed requirement would mirror the statutory text in terms of the representations that would need to be made in the attestation.[500]

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (a)(1)(iii) of proposed Rule 17g-7. The Commission also seeks comment on the following:

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497 See 15 U.S.C. 78o-7(s) and 15 U.S.C. 78o-7(q).

498 See 15 U.S.C. 78o-7(s).

499 See proposed new paragraphs (a)(1)(iii)(A)-(C) of Rule 17g-7.

500 Compare proposed new paragraphs (a)(1)(iii)(A)-(C) of Rule 17g-7, with 15 U.S.C. 78o-7(q)(2)(F).

1. Are there alternative means of implementing Section 15E(q)(2)(F) with respect to the attestation requirement? For example, should Section 15E(q)(2)(F) be implemented in proposed provisions requiring NRSROs to disclose information about the performance of credit ratings (i.e., the proposed Form NRSRO Exhibit 1 Transition/Default Matrices and/or the proposed ratings histories disclosure requirement)? If so, how would the attestation requirement be made a part of either of these other proposals?
2. What person within the NRSRO has responsibility for the credit rating and the other information that would be required to be disclosed in the form and, consequently, could make the attestation? For example, could the lead analyst, the chair of the rating committee, a senior manager, or some other person make the proposed attestation?

#### 5. Paragraph (a)(2) – Certification of Third-Party Due Diligence Provider

Section 15E(s)(4)(B) of the Exchange Act requires a third-party providing due diligence services to an NRSRO, issuer, or underwriter with respect to an Exchange Act-ABS[501] to provide a written certification to any NRSRO that produces a credit rating to which the due diligence services relate.[502] Section 15E(s)(4)(D) of the Exchange Act provides that the Commission shall adopt a rule requiring an NRSRO that receives a certification from a provider of third-party due diligence services to disclose the certification to the public in a manner that allows the public to

501 See 15 U.S.C. 78o-7(s)(4)(A)-(D). As noted earlier, the term "structured finance product" as used throughout this release refers broadly to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This broad category of financial instrument includes an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)) and other types of structured debt instruments such as CDOs, including synthetic and hybrid CDOs. The term "Exchange Act-ABS" as used throughout this release refers more narrowly to an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act. 15 U.S.C. 78c(a)(77).

502 See 15 U.S.C. 78o-7(s)(4)(B).

determine the adequacy and level of the due diligence services provided by the third-party.[503] The Commission preliminarily believes that this goal could best be achieved by requiring the NRSRO to disclose any such certifications with the publication of the NRSRO's credit rating to which the certification relates. Therefore, the Commission is proposing to add a new paragraph (a)(2) to Rule 17g-7 that, in conjunction with the proposed prefatory text of paragraph (a), would provide that the NRSRO must include with the publication of a credit rating any written certification related to the credit rating received from a provider of third-party due diligence services pursuant to Section 15E(s)(4)(B) of the Exchange Act.[504]

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (a)(2) of Rule 17g-7. The Commission also seeks comment on the following:

1. Would it be appropriate to require the inclusion of the certification of the provider of third-party due diligence services with the publication of the credit rating and the form containing information about the credit rating? Is there an alternative means of disclosing the certifications that would be reasonably designed to ensure they are disseminated to users of the NRSRO's credit ratings? If so, describe the method of disclosure.

## H. THIRD-PARTY DUE DILIGENCE FOR ASSET-BACKED SECURITIES

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new paragraph (s), which, as discussed above in Section II.G of this release, has four subparagraphs: (1), (2), (3) and (4).[505] Section 15E(s)(4), "Due diligence services for asset-

503 See 15 U.S.C. 78o-7(s)(4)(D).

504 See proposed paragraph (a)(2) of Rule 17g-7.

505 See Pub. L. No. 111-203 § Section 932(a)(8) and 15 U.S.C. 78o-7(s)(1)-(4).

backed securities," contains four provisions regarding due diligence services relating to an Exchange Act-ABS. Section 15E(s)(4)(A) requires the issuer or underwriter to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.[506] Section 15E(s)(4)(B) requires that in any case in which third-party due diligence services are employed by an NRSRO, an issuer, or an underwriter, the person providing the due diligence services shall provide to any NRSRO that produces a rating to which such services relate, written certification in a format as provided in Section 15E(s)(4)(C).[507] Section 15E(s)(4)(C) of the Exchange Act provides that the Commission shall establish the appropriate format and content for the written certifications required under Section 15E(s)(4)(B), to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate rating.[508] Finally, Section 15E(s)(4)(D) of the Exchange Act provides that the Commission shall adopt rules requiring an NRSRO, at the time at which the NRSRO produces a rating, to disclose the certification described in Section 15E(s)(4)(B) to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party.[509]

As discussed below in Section II.H.1 of this release, the Commission is proposing to implement Section 15E(s)(4)(A) of the Exchange Act by proposing amendments to Rule 314 of Regulation S-T and Form ABS-15G, and proposing new Rule 15Ga-2.[510] In addition, as

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506 See 15 U.S.C. 78o-7(s)(4)(A).

507 See 15 U.S.C. 78o-7(s)(4)(B).

508 See 15 U.S.C. 78o-7(s)(4)(C).

509 See 15 U.S.C. 78o-7(s)(4)(D).

510 See proposed amendments to Rule 314 of Regulation S-T and Form ABS-15G and proposed new Rule 15Ga-2. New Rule 15Ga-2 would be codified at 17 CFR 240.15Ga-2.

discussed below in Sections II.H.2 and II.H.3 of this release, the Commission is proposing to implement Sections 15E(s)(4)(B) and (C) of the Exchange Act by proposing new Rule 17g-10 and a related form – Form ABS Due Diligence-15E.[511] As discussed above in Section II.G.5 of this release, the Commission is proposing to implement Section 15E(s)(4)(D) by proposing new paragraph (a)(2) to Rule 17g-7.[512]

Before discussing the proposals to implement Sections 15E(s)(4)(A) through (C), the Commission notes the provisions of Section 15E(s)(4) raise two fundamental questions: (1) how will a provider of third-party due diligence services know the identities of the NRSROs producing credit ratings to which its services relate (particularly NRSROs producing unsolicited credit ratings); and (2) when must the certification be provided to the NRSROs? Accordingly, the Commission is requesting comment on these questions in order to consider further guidance or rulemaking to better determine how a provider of third-party due diligence services can comply with the requirement in Section 15E(s)(4)(B) of the Exchange Act.[513]

Request for Comment

The Commission generally requests comment on all aspects of Section 15E(s)(4)(B) of the Exchange Act. The Commission also seeks comment on the following:

1. How would a provider of third-party due diligence services identify the NRSROs producing credit ratings to which the due diligence services relate? For example, would it be sufficient for the provider of third-party due diligence services to contractually require issuers and underwriters that employ it to provide these services to identify the

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511 See proposed new Rule 17g-10 and Form ABS Due Diligence-15E. New Rule 17g-10 would be codified at 17 CFR 240.17g-10 and Form ABS Due Diligence 15E would be identified in the Code of Federal Regulation at 17 CFR 249b.400.

512 See proposed new paragraph (a)(2) of Rule 17g-7.

513 15 U.S.C. 78o-7(s)(4)(B).

NRSROs engaged by the issuer or underwriter to produce credit ratings for the Exchange Act-ABS and to identify any other NRSROs the issuers and underwriters have notice are producing unsolicited credit ratings for the Exchange Act-ABS? Would issuers and underwriters agree to such contractual terms or would they use a provider of third-party due diligence services that does not demand such terms? Even if issuers and underwriters agree to such contractual terms, would they know the identity of every NRSRO producing a credit rating for the Exchange Act-ABS, particularly NRSROs producing unsolicited credit ratings? Would an appropriate mechanism for providing the certifications to all NRSROs producing a credit rating for the Exchange Act-ABS be to disclose it with the information required by paragraph (a)(3) of Rule 17g-5 (which requires, among other things, the issuer or underwriter to make the information provided to an NRSRO hired to produce a credit rating for a structured finance product such as an Exchange Act-ABS available to any other NRSRO)?[514]

2. In the case where an NRSRO (as opposed to the issuer or underwriter) employs the provider of third-party due diligence services, how would the NRSRO know of any other NRSROs that are producing credit ratings to which the due diligence services relate and provide the identities of such NRSROs to the provider of the third-party due diligence services? If paragraph (a)(3) of Rule 17g-5 would be an appropriate mechanism for providing the certifications to all NRSROs producing a credit rating for the Exchange Act-ABS, could the hired NRSRO obtain a representation from the issuer or underwriter that it would make any certifications received by the NRSRO available to other NRSROs

[514] 17 CFR 240.17g-5(a)(3).

through the process by which the issuer or underwriter makes the information required by paragraph (a)(3) of Rule 17g-5 available to other NRSROs?

3. Should there be some type of centralized database where NRSROs producing credit ratings for an Exchange Act-ABS identify themselves and which would be deemed constructive notice to any provider of third-party due diligence services that is providing services related to the Exchange Act-ABS? If so, should the Commission administer this centralized database or should the issuers and underwriters, providers of third-party due diligence services, NRSROs, or users of credit ratings administer this database?

4. Should there be a centralized database where a provider of third-party due diligence services submits its certification for publication, and should submitting the certification to such a database be deemed constructive receipt by an NRSRO producing a credit rating for an Exchange Act-ABS to which the due diligence services described in the certification relate? Should this database also be the mechanism by which issuers and underwriters make publicly available, pursuant to the requirement in Section 15E(s)(4)(A) of the Exchange Act, the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter? If so, should the Commission administer this centralized database or should the issuers and underwriters, providers of third-party due diligence services, NRSROs, or users of credit ratings administer this database? For example, should the certification be furnished or filed on the Commission's EDGAR system?

5. Should there be a reasonableness test in terms of assessing whether the provider of third-party due diligence services submitted the certification to all NRSROs required to receive the certification? For example, should the provider of third-party due diligence services

be required to provide the certification to all NRSROs it knows or reasonably should know are producing a credit rating for which its services relate?

6. How soon after the provider of third-party due diligence services completes its review should the certifications be provided to all NRSROs required to receive it? For example, should the certification be provided "promptly" or within 24 hours, 2 business days, 10 business days, or some other period of time?
7. Should the provider of third-party due diligence services be required to provide the certification to all required NRSROs at the same time so that no single NRSRO has the benefit of using the certification before the other NRSROs that are required to receive it? How would such a requirement be implemented and enforced in practice?
8. Should the requirement to provide the certification to all NRSROs required to receive it sunset after some period of time after the due diligence services are completed such as 30, 60, 90, 120, 150, 180 days or some longer period? For example, should the provider of third-party due diligence services be required to provide the certification to any NRSRO that produces a credit rating to which its services relate until the security matures, is called, is pre-paid, or goes into default?
9. If the provider of third-party due diligence services is hired to provide due diligence services with respect to an initial issuance of securities, would it need to provide the certification at some later time to an NRSRO that does not rate the securities initially but produces a credit rating after the securities have been outstanding for a period of time?

### i. Proposed Rule 15Ga-2 and Amendments to Form ABS-15G

The Commission is re-proposing rules, with some revisions, to implement Section 15E(s)(4)(A) of the Exchange Act, which requires that an issuer or underwriter of any Exchange

Act-ABS make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.[515] The Commission previously proposed to implement Section 15E(s)(4)(A) of the Exchange Act as part of a set of rules proposed to implement Section 945 of the Dodd-Frank Act.[516] Under those proposals, an issuer of a registered Exchange Act-ABS offering would have been required to disclose the findings and conclusions of any third party engaged to perform a review obtained by the issuer, as required by Section 15E(s)(4)(A), in the prospectus.[517] In the case of unregistered Exchange Act-ABS offerings, the Commission proposed new Rule 15Ga-2.[518] This rule would have required an issuer of Exchange Act-ABS to file a new Form ABS-15G to disclose the findings and conclusions of any third-party engaged to perform a review obtained by an issuer with respect to unregistered transactions.[519] Proposed Rule 15Ga-2 also would have required an underwriter of Exchange Act-ABS to file Form ABS-15G with the same information for reports obtained by an underwriter in registered and unregistered transactions.[520] Finally, proposed Form ABS-15G

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515 See 15 U.S.C. 78o-7(s)(4)(A).

516 See Issuer Review of Assets in Offerings of Asset-Backed Securities, Securities Act Release No. 9150 (Oct. 13, 2010), 75 FR 64182 (Oct. 19, 2010). In the same release in which the Commission proposed to implement Section 15E(s)(4)(A), the Commission also proposed to implement Section 7(d) of the Securities Act(15 U.S.C. 77g(d)), as added by Pub. L. No. 111-203 § 945. Section 7(d) of the Securities Act requires the Commission to adopt rules that, with respect to a registration statement for an asset-backed security, will require the issuer of the security to: (1) perform a review of the assets underlying the asset-backed security; and (2) disclose the nature of the review. See 15 U.S.C. 77g(d)(1) and (2). The Commission implemented this provision by adopting new rule 17 CFR 230.193 ("Rule 193") and amendments to 17 CFR 229.1111 ("Item 1111 of Regulation AB"). See Issuer Review of Assets in Offerings of Asset-Backed Securities, Securities Act Release No. 9176 (Jan. 20, 2011), 76 FR 4231 (Jan. 25, 2011).

517 See Issuer Review of Assets in Offerings of Asset-Backed Securities, 75 FR at 64188-64190 (Oct. 19, 2010).

518 Id.

519 Id.

would have been required to be filed with the Commission on EDGAR five business days prior to the first sale of the offering.[521]

With respect to these proposals, the Commission requested comment on, among other things, whether rules implementing Section 15E(s)(4)(A) of the Exchange Act should be part of a later rulemaking under Section 15E.[522] Some commenters stated that Section 15E(s)(4) should be read as a whole, and that it would be inappropriate to consider subsection (A) alone.[523] These commenters suggested postponing implementation of Section 15E(s)(4)(A) until the Commission implements Section 15E(s)(4)(B), (C) and (D).[524] These commenters argued that Rule 15Ga-2, as proposed, would have "construe[d] Section 15E(s)(4)(A) in a vacuum, divorced from Congress' intent to regulate NRSROs and the credit ratings process."[525] These commenters also argued that proposed Rule 15Ga-2 was inappropriately broad. One such commenter suggested that Rule 15Ga-2 be modified to apply only to any third-party due diligence report prepared for an issuer or underwriter of Exchange Act-ABS specifically for the purpose of having the issuer or underwriter share the report with an NRSRO issuing a credit rating for the securities.[526]

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520 Id.

521 Id.

522 Id.

523 See comment letters from American Bar Association ("ABA"); National Association of Bond Lawyers ("NABL") (responding to Issuer Review of Asset in Offerings of Asset-Backed Securities, 75 FR 64182 (Oct. 19, 2010)). The comment letters are available at http://sec.gov/comments/s7-26-10/s72610.shtml.

524 See comment letters from ABA and NABL.

525 See comment letters from ABA and NABL.

526 See comment letter from ABA.

In January 2011, the Commission adopted rules implementing Section 7(d) of the Securities Act and, at the same time, deferred action on implementing Section 15E(s)(4)(A).[527] After considering the comment letters relating to Section 15E(s)(4)(A), the Commission is re-proposing Rule 15Ga-2 with revisions.[528] As proposed in October 2010, Rule 15Ga-2 would have required issuers and underwriters of Exchange Act-ABS to file Form ABS-15G containing, or provide prospectus disclosure with respect to, the findings and conclusions of any report of a third-party engaged for purposes of performing a review of the pool assets obtained by the issuer or underwriter.[529] As noted above, the Commission included this proposal in the context of rulemaking with respect to issuer review of assets required by Section 7(d) of the Securities Act.[530]

After reviewing the comments, the Commission now believes that Section 15E(s)(4)(A) of the Exchange Act, when considered in the context of Sections 15E(s)(4)(B), (C) and (D), should be interpreted more narrowly to relate to those provisions.[531] Therefore, as re-proposed, Rule 15Ga-2 would require an issuer or underwriter of any Exchange Act-ABS that is to be rated by an NRSRO to furnish a Form ABS-15G on the EDGAR system containing the findings and

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527 See Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 FR 4231 (Jan. 25, 2011). Although the Commission deferred action on implementing Section 15E(s)(4)(A), the Commission adopted, in a separate release, new Form ABS-15G to implement Section 943 of the Dodd-Frank Act. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 4489 (Jan. 26, 2011).

528 See proposed new Rule 15Ga-2. The Commission also is proposing conforming amendments to Form ABS-15G.

529 See Issuer Review of Assets in Offerings of Asset-Backed Securities, 75 FR at 64188-64190 (Oct. 19, 2010).

530 See Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 FR 4231 (Jan. 25, 2011).

531 See 15 U.S.C 78o-7(s)(4)(A) through (D), which relate to due diligence performed by third-parties with respect to Exchange Act-ABS.

conclusions of any third-party "due diligence report" obtained by the issuer or underwriter.[532] The rule would define "due diligence report" as any report containing findings and conclusions relating to "due diligence services" as defined in proposed new Rule 17g-10 discussed below in Section II.H.2 of this release. Under the re-proposal, the disclosure would be furnished using Form ABS-15G for both registered and unregistered offerings of Exchange Act-ABS.[533] Thus, unlike the October 2010 proposal, discussed above, issuers in registered Exchange Act-ABS offerings would not be required to include the disclosure in their prospectuses.

In addition, under the Commission's re-proposal, an issuer or underwriter would not need to furnish Form ABS-15G if the issuer or underwriter obtains a representation from each NRSRO engaged to produce a credit rating for the Exchange Act-ABS that can be reasonably relied on that the NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7.[534] As discussed above in Section II.G.3 of this release, proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7 would

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532. See proposed new Rule 15Ga-2 and conforming changes to Form ABS-15G. For purposes of this rule, consistent with the definition of "issuer" in proposed new Rule 17g-10, the issuer is the depositor or sponsor that participates in the issuance of Exchange Act-ABS. See discussion below in Section II.H.2 of this release.

533 The Commission is proposing that the form be deemed "furnished" rather than "filed" for purposes of Section 18 of the Exchange Act (15 U.S.C. 78r) and the liabilities of that section, unless the issuer specifically states that the form be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

534 See 15 U.S.C. 78o-7(s)(3)(A)(v). In this context, the Commission preliminarily believes that the term "publicly disclose" means make the findings and conclusions readily available to any users of credit ratings. Consequently, an NRSRO that agreed to make the findings and conclusions available only to its subscribers or prospective investors in the Exchange Act-ABS would not satisfy this proposed requirement.

implement Section 15E(s)(3)(A)(v) of the Exchange Act by requiring an NRSRO to disclose in the form whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third-party. In addition, as discussed below in Section II.H.3 of this release, the Commission is proposing that the certification a provider of third-party due diligence services would need to provide to an NRSRO producing a credit rating for an Exchange Act-ABS pursuant to Section 15E(s)(4)(B) and (C) include a summary of the findings and conclusions of the provider of third-party due diligence services.[535] And, as discussed above in Section II.G.5 of this release, an NRSRO would be required to include the certification with the publication of the credit rating.[536]

For these reasons, having the issuer and underwriter publicly disclose the same information an NRSRO must, when applicable, disclose pursuant to proposed new paragraphs (a)(1)(ii)(F) and (a)(2) of Rule 17g-7 with the publication of a credit rating would be redundant. Moreover, as discussed earlier, potential investors in Exchange Act-ABS may be accustomed to receiving and reviewing expected or preliminary credit ratings issued by NRSROs prior to making an investment decision and proposed new paragraph (a) of Rule 17g-7 would require the form and any certifications to be included with the issuance of such credit ratings. Therefore, the Commission believes that an effective means of disseminating this information to investors and other users of credit ratings would be to include it with the publication of the credit rating. Also, because the form would contain substantial additional information, consolidating the information in one disclosure would benefit investors and other users of credit ratings.

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535 See Item 5 of proposed new Form ABS Due Diligence-15E.

536 See proposed new paragraph (a)(2) of Rule 17g-7.

As noted above, the issuer or underwriter would not need to furnish Form ABS-15G if it obtained a representation from each NRSRO engaged to produce a credit rating upon which the issuer or underwriter could reasonably rely.[537] The Commission preliminarily recognizes, however, that there may be instances where, notwithstanding an issuer's or underwriter's reasonable reliance on a representation by an NRSRO engaged to produce a credit rating to publicly disclose the required information, the NRSRO fails to make such information publicly available in its information disclosure form pursuant to proposed Rule 17g-7(a)(1) five business days prior to the first sale in the offering.[538] Therefore, the Commission proposes to require that an issuer or underwriter furnish, two business days prior to the first sale in the offering, Form ABS-15G with the information required by proposed Rule 15Ga-2 if the NRSRO fails to comply with its representation to make such information publicly available in an information disclosure form generated pursuant to proposed paragraph (a)(1) of Rule 17g-7 five business days prior to the first sale in the offering. Under the proposal, issuers or underwriters would be permitted to reasonably rely on a representation by an NRSRO to meet their obligation to publicly disclose the information required to be provided in Form ABS-15G. However, they would continue to be responsible for furnishing Form ABS -15G two business days prior to the first sale in the offering if the NRSRO does not publicly disclose the information five business days prior to the first sale in the offering.

537 The issuer or underwriter would be required to provide to the Commission, upon request, information regarding the manner in which it obtained the representation. The Commission notes that in most cases the NRSROs likely would have an independent obligation to disclose the information pursuant to the proposed amendments to Rule 17g-7 and proposed new Rule 17g-10 and Form ABS Due Diligence-15E.

538 The NRSRO's failure to disclose the certification would be a violation of proposed paragraph (a) of Rule 17g-7.

This "reasonable reliance" provision would parallel requirements in paragraph (a)(3) of Rule 17g-5 that require an NRSRO to obtain certain representations from arrangers of structured finance products that hire the NRSRO to determine a credit rating for the structured finance product.[539] When adopting this requirement the Commission stated, "The question of whether reliance was reasonable will depend on the facts and circumstances of a given situation."[540] The Commission further stated, "The factors relevant to this analysis would include, but not be limited to: (1) ongoing or prior failures by the arranger to adhere to the representations; or (2) a pattern of conduct by the arranger where it fails to promptly correct breaches of its representations."[541] The Commission preliminarily believes that the same would hold true with respect to relying on the representations from NRSROs obtained for the purposes of proposed Rule 15Ga-2.

The Commission notes that Rule 193, adopted to implement Section 7(d) of the Securities Act, requires issuers of registered Exchange Act-ABS to perform a review of the pool assets underlying the asset-backed security.[542] This review must be designed and effected to provide reasonable assurance that the prospectus disclosure regarding the pool assets is accurate in all material respects.[543] Although third-party due diligence reports may be relevant to the review, neither Section 7(d) of the Securities Act nor Rule 193 ties the review to third-party due

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539 See 17 CFR 17g-5(a)(3); see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63844-63850 (Dec. 4, 2009).

540 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63847 (Dec. 4, 2009).

541 Id.

542 See 17 CFR 230.193.

543 Id.

diligence reports.[544] Rule 193 permits, though does not require, an issuer to rely on one or more third parties to fulfill its obligation to perform the required review.[545]

The Commission recognizes Exchange Act-ABS issuers may routinely hire third-parties to conduct various types of reviews and believes that issuers may employ third parties to assist in satisfying their obligations to perform a review under Rule 193.[546] The Commission also recognizes that an issuer of Exchange Act-ABS may obtain a third-party due diligence report from a third party the issuer has engaged to assist in performing its Rule 193 review. Nonetheless, the Commission believes that the third-party due diligence reports referenced in Section 15E(s)(4) of the Exchange Act are not the same as the review required by Section 7(d) of the Securities Act and Rule 193.[547] Instead, Section 15E(s)(4) of the Exchange Act and, consequently, proposed Rule 15Ga-2 relate to a particular type of report that is relevant to the determination of a credit rating by an NRSRO. By contrast, Section 7(d) of the Securities Act and Rule 193 relate to a more general concept of an issuer review of the assets underlying an Exchange Act-ABS, one aspect of which may (or may not) include a third-party due diligence report. As a result, the treatment of due diligence reports under proposed Rule 15Ga-2 is not predicated on the use of third-party due diligence services to assist with reviews under Rule 193.[548] For these reasons, the Commission also is proposing that Rule 15Ga-2 apply only with respect to Exchange-Act ABS that are to be rated by an NRSRO.[549]

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544 See 15 U.S.C. 77g(d) and 17 CFR 230.193.

545 Id.

546 The Commission also notes that an issuer may rely on multiple third-parties to fulfill its Rule 193 review obligation, provided the issuer complies with the requirements of Rule 193 for each third party.

547 Compare 15 U.S.C. 77g(d) and 17 CFR 230.193, with 15 U.S.C. 78o-7(s)(4).

548 The Commission does not intend for all third-parties from whom the issuer obtains a third-party due diligence report, as defined in proposed Rule 15Ga-2, to be named in the

As noted above, the disclosure required by proposed Rule 15Ga-2 would be required to be provided in Form ABS-15G. Unlike the first proposal, the Commission now proposes to require issuers in registered Exchange Act-ABS transactions to include the disclosure required by proposed Rule 15Ga-2 in Form ABS-15G, rather than in the prospectus. Whether the findings and conclusions of a third-party are part of the Rule 193 review and, therefore, included in the prospectus disclosure is dictated by the requirements of Rule 193 and Item 1111 of Regulation AB.[550] The Commission is not proposing to separately require that disclosure provided in connection with Rule 15Ga-2 regarding any third-party due diligence report be provided in the prospectus for a registered offering, because the information required by proposed Rule 15Ga-2 only pertains to the findings and conclusions of a third-party due diligence report relevant to the determination of a credit rating.

As stated above, Section 15E(s)(4)(A) applies to issuers and underwriters of both registered and unregistered offerings of Exchange Act-ABS. Thus, proposed Rule 15Ga-2 would apply to a municipal entity that sponsors or issues Exchange Act-ABS ("municipal Exchange Act-ABS") or an underwriter of municipal Exchange Act-ABS, if the municipal entity or underwriter of the offering obtains a third-party due-diligence report, as defined by the proposed rule, and the municipal Exchange Act-ABS is to be rated by an NRSRO. Since Section 15E(s)(4) relates to oversight of NRSROs, commenters to the first proposal noted that a

registration statement and consent to being named as an expert, in accordance with the requirements in Rule 193, solely because an issuer files Form ABS-15G. If the issuer's prospectus disclosure attributes the findings and conclusions of the Rule 193 review to the third-party from whom it obtains a third-party due diligence report, however, the third-party would be required to be named in the registration statement and consent to being named as an expert in accordance with Rule 436 under the Securities Act.

549 See proposed new Rule 15Ga-2.

550 See 17 CFR 230.193 and 17 CFR 229.1111.

significant difference between municipal Exchange Act-ABS and more typical Exchange Act-ABS is that the Municipal Securities Rulemaking Board[551] collects and publicly disseminates market information and information about municipal securities issuers and offerings on its centralized public database, the Electronic Municipal Market Access system ("EMMA").[552] Consistent with suggestions from commenters and the Commission's approach in implementing Section 943 of the Dodd-Frank Act,[553] the Commission proposes to permit municipal securitizers of Exchange Act-ABS, or underwriters in the offering, to provide the information required by Form ABS-15G on EMMA.[554] The Commission believes this would limit the cost and burden on issuers and underwriters of municipal Exchange Act-ABS subject to the new rule, as well as provide the disclosure for investors in the same location as other disclosures regarding municipal ABS. Since Section 15E(s)(4) relates to oversight of NRSROs and the ratings process, the Commission preliminarily believes it is not appropriate to exempt any particular issuers if they receive a rating for the securities.[555]

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551 The MSRB, a self-regulatory organization subject to oversight by the Commission, regulates securities firms and banks that underwrite, trade and sell municipal securities.

552 See comment letters from Minnesota Housing Finance Agency, NABL, and the National Council of State Housing Agencies (responding to proposals in Issuer Review of Assets in Offerings of Asset-Backed Securities, 75 FR 64182 (Oct. 19, 2010)).

553 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 4489 (Jan. 26, 2011).

554 See proposed amendments to Rule 314 of Regulation S-T. 17 CFR 232.314. A municipal securitizer is defined as a securitizer (as that term in defined in Section 15(G)(a) of the Exchange Act (__ U.S.C. ___)) that is any State or Territory of the United States, the District of Columbia, any political subdivision of any State, Territory, or the District of Columbia, or any public instrumentality of one or more States, Territories, or the District of Columbia.

555 As noted earlier, the Commission is soliciting comment in Section II.M.4.a of this release with respect Items 6 and 7 of Form NRSRO about how certain types of obligors, securities, and money market instruments should be classified for purposes of providing the approximate number of credit ratings outstanding in each class of credit rating for which an applicant is seeking registration (Item 6) or an NRSRO is registered (Item 7).

The Commission recognizes that public disclosure of information relating to an unregistered Exchange Act-ABS offering could raise concerns regarding the reliance by an issuer or underwriter on the private offering exemptions and safe harbors under the Securities Act.[556] As noted above, the Commission intends for Form ABS-15G to be used for both registered and unregistered ABS offerings. The Commission is of the view that issuers and underwriters can disclose information required by Rule 15Ga-2 without jeopardizing reliance on those exemptions and safe harbors, provided the only information made publicly available on the form is that which is required by the proposed rule, and the issuer does not otherwise use Form ABS-15G to offer or sell securities in a manner that conditions the market for offers or sales of its securities.[557]

The Commission is proposing that the disclosures – whether made by the engaged NRSROs or the issuer or underwriter – be made five business days prior to the first sale of the

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In this regard, the Commission solicits comment on whether municipal structured finance issuers should be classified as (1) issuers of asset-backed securities identified in Section 15E(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction; or (2) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 15E(a)(62)(A)(v) of the Exchange Act. The Commission is requesting comment on this matter with respect to disclosing the number of credit ratings outstanding in a particular class of credit ratings in Form NRSRO (and potentially for purposes of the proposed amendments to Exhibit 1 to Form NRSRO and the disclosure of information about the histories of credit ratings under proposed new paragraph (b) of Rule 17g-7). The Commission, in seeking comment on these matters, is not suggesting an issuer of municipal Exchange Act-ABS should be exempt from requirements in the securities laws that apply to Exchange Act-ABS because it might appropriately be classified as an issuer of government securities, municipal securities, or securities issued by a foreign government identified in Section 15E(a)(62)(A)(v) of the Exchange Act for purposes of Items 6 and 7 of Form NRSRO.

556 See 15 U.S.C. 77d(2), 17 CFR 230.144A, and 17 CFR 230.501-508.

557 Furnishing proposed Form ABS-15G would not foreclose the reliance of an issuer on the private offering exemption in the Securities Act and the safe harbor for offshore transactions from the registration provisions in Section 5. 15 U.S.C. 77e.

offering. Since the form an NRSRO would be required to include with a credit rating pursuant to proposed new paragraph (a) of Rule 17g-7 would not be required to be filed with the Commission, the Commission believes it would be consistent to permit issuers and underwriters to furnish, rather than file, Form ABS-15G. The Commission proposes that Form ABS-15G be signed by the senior officer of the depositor in charge of securitization, if the form were provided to include the findings and conclusions of a third-party hired by the issuer. The Commission believes that requiring the senior officer of the depositor in charge of securitization to sign the form is consistent with other signature requirements for filings relating to Exchange Act-ABS.[558] If the form included the findings and conclusions of a third-party engaged by the underwriter, then the form would be signed by a duly authorized officer of the underwriter. The Commission believes that requiring Form ABS-15G be signed by a duly authorized officer of the underwriter would provide an incentive for the person who signs the form to review it for accuracy.

Request for Comment

The Commission generally requests comment on all aspects of proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G. The Commission also seeks comment on the following:

1. Is proposed Rule 15Ga-2 appropriate? Is the proposed definition of "third-party due diligence report" appropriate? Is there an alternative definition that would be consistent with the requirements of Section 15E(s)(4)?
2. The Commission is proposing to require disclosure regarding the findings and conclusions of third-party due diligence reports for both registered and unregistered

558 See, e.g., signature requirement for Form 10-K (17 CFR 249.312). It is also consistent with the Commission's proposed signature requirements for the registration statements for offerings of asset-backed securities. See Asset-Backed Securities, 75 FR 23328 (May 3, 2010).

transactions. Is there any reason Section 15E(s)(4)(A) of the Exchange Act should not apply to both registered and unregistered Exchange Act-ABS transactions? If the requirement applies to both registered and unregistered transactions, should the universe of Exchange Act-ABS offerings that would be subject to the requirement be defined, as proposed, as an offering of Exchange Act-ABS, as that term is defined in Section 3(a)(77) of the Exchange Act?

3. Proposed Rule 15Ga-2 would apply only if the Exchange Act-ABS is to be rated by a NRSRO. Is that appropriate?[559] Why or why not?

4. Should the Commission exempt any issuers, underwriters or other parties from this requirement? As proposed, Rule 15Ga-2 would apply to issuers and underwriters of Exchange Act-ABS that are exempted securities as defined in Section 3(a)(12) of the Exchange Act, including government securities and municipal securities. Should issuers or underwriters of such exempted securities be exempt from this provision?[560] Is the proposed accommodation for municipal Exchange Act-ABS appropriate?

5. Is the proposal to not require the issuer or underwriter to furnish Form ABS-15G if it obtains the necessary representations from the NRSROs engaged to produce credit ratings for the Exchange Act-ABS appropriate? For example, would investors and other

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559 For example, Fannie Mae and Freddie Mac are government sponsored enterprises ("GSEs") that purchase mortgage loans and issue or guarantee mortgage-backed securities. Mortgage-backed securities issued or guaranteed by these GSEs have been, and continue to be, exempt from registration under the Securities Act and reporting requirements under Sections 13 or 15 of the Exchange Act. These securities have not been, and are not currently, rated by credit rating agencies.

560 Exchange Act "exempted securities" include government securities and municipal securities, as defined under the Exchange Act. For example, mortgage-backed securities issued by the Government National Mortgage Association are fully modified pass-through securities guaranteed by the full faith and credit of the United States government. See http://www.ginniemae.gov/.

users of credit ratings benefit from having issuers and underwriters and NRSROs disclose the findings and conclusions of the provider of third-party due diligence services? In addition, would NRSROs engaged to determine a credit rating for an Exchange Act-ABS agree to make the disclosure? Could potential concerns among NRSROs about making the disclosure be addressed by permitting them to rely on the disclosure the provider of third-party due diligence services would need to make about the findings and conclusions of the review in Item 5 of proposed new Form Due Diligence-15E discussed below in Section II.H.3 of this release?

Under proposed Rule 15Ga-2, an issuer or underwriter would not be required to furnish Form ABS-15G if it receives a representation from an NRSRO that can be reasonably relied upon that the NRSRO will publicly disclose the required information five business days prior to the first sale in the offering in an information disclosure form generated pursuant to Rule 17g-7(a)(1). Should the Commission, as proposed, also require an issuer or underwriter to furnish Form ABS-15G if the NRSRO fails to publicly disclose in an information disclosure form the required disclosure five business days prior to the first sale in the offering? If so, should the issuer or underwriter be required, as proposed, to furnish Form ABS-15G two business days prior to the first sale in the offering? Should the requirement instead be three days before? Alternatively, should the Commission require that the issuer or underwriter wait another five business days after furnishing Form ABS-15G before the first sale? If not, how long in advance of the first sale should issuers or underwriters be required to furnish Form ABS-15G? Should an issuer or underwriter not be required to furnish Form ABS-15G two business days prior to the first sale in the offering if the NRSRO fails to publicly disclose the required information five business days prior to the first sale, but does publicly disclose the information on the fourth or third business day prior to the first sale since an issuer's or underwriter's furnishing in that case would result in duplicative disclosure? If so, how could an NRSRO be properly incentivized to publicly disclose the required information five business days prior to the first sale in the offering?

6. Does the proposal to require an issuer or underwriter to furnish Form ABS-15G in the event that the NRSRO fails to fulfill its representation offset the effectiveness or benefit of the proposal to permit issuers and underwriters to reasonably rely on a representation from an NRSRO?

7. Under the proposal, the issuer or underwriter would be required to provide to the Commission, upon request, information regarding the manner in which it obtained the representation of the NRSRO engaged to produce credit ratings. Are there any other provisions that should be added to ensure compliance with the proposal not to require the issuer or underwriter to furnish Form ABS-15G if it obtains the necessary representations from the NRSRO?

8. Are there other appropriate means of making the findings and conclusions of third-party due diligence reports "publicly available" as required by Section 15E(s)(4)(A) of the Exchange Act? Is furnishing information regarding the findings and conclusions of the report of the provider of third-party due diligence services on proposed Form ABS-15G on EDGAR (except with respect to offerings of municipal Exchange Act-ABS) an appropriate way for issuers in unregistered offerings and for underwriters in registered and unregistered offerings to make this information publicly available? Should the Form ABS-15G be required to be filed instead?

9. Would the proposed requirement that Form ABS-15G be furnished five business days prior to first sale provide investors with sufficient time to review the findings and conclusions contained therein? Would it provide NRSROs with sufficient time to take the included information into account in determining a rating? If not, what would be a more appropriate deadline and why? Are five business days also appropriate in unregistered offerings? Is there reason to require a different number of days in unregistered offerings?
10. Is the proposed signature requirement for Form ABS-15G appropriate? Is it necessary? Conversely, are there other appropriate individuals that are better suited to sign the form?
11. Should issuers of registered Exchange Act-ABS offerings be required to furnish the information required by proposed Rule 15Ga-2 on Form ABS-15G and not be required to provide the information in a prospectus that is filed with the Commission, as proposed? Why or why not?

**2. Proposed New Rule 17g-10**

As noted above, Section 15E(s)(4)(C) of the Exchange Act provides that the Commission shall establish the appropriate format and content for the written certifications required under Section 15E(s)(4)(B), to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate rating for an Exchange Act-ABS.[561] The Commission preliminarily believes providers of third-party due diligence services most commonly are hired by issuers and underwriters to perform reviews of pools of mortgages that will be securitized into an RMBS; accordingly, the following discussion of proposed Rule 17g-10 and Form ABS Due

[561] See 15 U.S.C. 78o-7(s)(4)(C).

Diligence-15E centers on RMBS.[562] The proposed rule and form, however, would apply to all Exchange Act-ABS. Generally, in the RMBS context, the provider of third-party due diligence services is hired by the entity (e.g., the underwriter, sponsor, or depositor) purchasing the pool of mortgage loans for the purpose of securitizing them.[563] In conducting a review, the provider of third-party due diligence services analyzes a sample (for example, 25%) of the loans in the pool for one or more of the following purposes: (1) to assess the quality of the loan-by-loan data in the electronic file ("loan-tape") that aggregates the information for the pool by comparing the information on the loan tape for each loan in the sample with the information contained on the hard-copy documents in the loan file; (2) to determine whether each loan in the sample adheres to the underwriting guidelines of the loan originator; (3) to assess the validity of the appraised value of the property indicated on the loan tape that collateralizes each loan in the sample; and (4) to determine whether the originator complied with federal, state, and local laws in making each loan in the sample. The NRSROs most active in rating RMBS have incorporated requirements for the engagement of providers of third-party due diligence services by the entities requesting such ratings (for example, the underwriter or sponsor of the RMBS) into their procedures and methodologies for determining RMBS credit ratings.[564] Moreover, the

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562 See, e.g., Testimony of Vicki Beal, Senior Vice President, Clayton Holdings, before the Financial Crisis Inquiry Commission (Sept. 23, 2010).

563 Id.

564 See, e.g., US RMBS Ratings Criteria, Fitch, Inc. ("Fitch") (Dec. 3, 2009) ("In addition to Fitch's originator/issuer review and ResiLogic loan-level asset analysis of the mortgage pool, Fitch will require third-party loan-level reviews on all residential mortgage pools that Fitch is asked to rate. The reviews will be conducted by a "due diligence" company (review company) prior to Fitch providing a rating on the transaction."); Criteria for Evaluating Independent Third-Party Loan Level Reviews for US RMBS, Moody's Investors Service, Inc. ("Moody's") (Nov. 24, 2008) ("Moody's will not rate a transaction unless it has received a report from the third-party review firm as to the TPR scope, procedure and findings. The report must include a narrative summary of the review and an initial TPR findings report."); Incorporating Third-Party Due Diligence Results Into

procedures and methodologies of these NRSROs prescribe the minimum scope and manner of the review of the provider of third-party due diligence services necessary to obtain a credit rating for the RMBS, including the minimum sample size of the loans to be selected from the pool.[565]

To implement the rulemaking mandated by Section 15E(s)(4)(C) of the Exchange Act, the Commission is proposing new Rule 17g-10 and related Form ABS Due Diligence-15E.[566] Proposed new Rule 17g-10 would contain three paragraphs: (a), (b) and (c).[567] Proposed paragraph (a) would provide that the written certification required pursuant to Section 15E(s)(4)(B) of the Exchange Act must be on Form ABS Due Diligence-15E.[568] In other words,

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The U.S. RMBS Rating Process, Standard & Poor's Ratings Services ("S&P") (Nov. 25, 2008) ("Standard & Poor's believes that using third-party due diligence results in our rating analysis will increase transparency and strengthen the rating process. Our due diligence review ratings criteria will be effective Dec. 1, 2008, and are intended to increase our insight into the quality and validity of the information used to originate the mortgage loans pooled into securities.").

565 For example, for established originators and loan programs, Fitch requires the randomly selected minimum sample size to be the larger of 200 loans or 10% of the pool for prime loans and the larger of 400 loans or 20% of the pool for Alt-A/subprime and all other product types. Moreover, if originators or their loan programs have had less than two years of performance history, Fitch requires that the sample size should be doubled. Moody's defines its minimum sample size through statistical techniques. Specifically, Moody's requires that the sample size must not be less than that computed using a 95% confidence level, a 5% precision level, and an assumed error rate equal to the higher of the historic error rate for the originator or a Minimum Assumed Error Rate. S&P requires a sample that is the greater of either the number of loans needed for a statistically valid sample, or a 10% random sample for subprime and 5% sample for prime. At a minimum, S&P states that the number of loans in the sample should be 200 for subprime, and 100 for prime. S&P defines a statistically valid sample as the number of loans based on a 5% one-tailed level of significance with a 2% level of precision. S&P also expects that the number of loans in the sample also will be a function of an estimate of an error rate.

566 See proposed new Rule 17g-10 and new Form ABS Due Diligence 15E.

567 See proposed paragraphs (a), (b) and (c) of Rule 17g-10.

568 See proposed paragraph (a) of new Rule 17g-10.

a provider of third-party due diligence services would need to use Form ABS Due Diligence-15E to meet the requirement in Section 15E(s)(4)(B) of the Exchange Act.[569]

Proposed paragraph (b) of new Rule 17g-10 would provide that the written certification must be signed by an individual who is duly authorized by the person providing the third-party due diligence services to make such a certification.[570] This proposal is designed to ensure that the person executing the certification on behalf of the provider of third-party due diligence services has responsibilities that will make the person aware of the basis for the information being provided in the form. This proposed requirement parallels paragraph (b) of Rule 17g-3, which requires an NRSRO to attach to the financial reports required by that rule a signed statement by a duly authorized person associated with the NRSRO stating, among other things, that the person has responsibility for the financial reports.[571]

Proposed paragraph (c) of new Rule 17g-10 would contain four definitions to be used for the purposes of Section 15E(s)(4)(B) and Rule 17g-10.[572] Proposed paragraph (c)(1) would define the meaning of "due diligence services."[573] The Commission preliminarily believes such a definition is necessary because, while the requirements of Section 15E(s)(4)(B) are triggered, among other things, by providing due diligence services, the Dodd-Frank Act does not define the type of activities that constitute "due diligence services" in the Exchange Act-ABS context.[574] Consequently, the Commission preliminarily believes a definition would provide guidance to those entities providing due diligence services as to when the requirements of the statute and

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569 See 15 U.S.C. 78o-7(s)(4)(B) and proposed paragraph (a) of new Rule 17g-10.

570 See proposed paragraph (b) of Rule 17g-10.

571 See 17 CFR 240.17g-3(b)

572 See proposed paragraph (c) of new Rule 17g-10 and 15 U.S.C. 78o-7(s)(4)(B).

573 See proposed paragraph (c)(1) of new Rule 17g-10.

574 See 15 U.S.C. 78o-7(s)(4)(B).

proposed new Rule 17g-10 would apply. In addition, a definition could help avoid overly broad interpretations of the meaning of "due diligence services" that cause entities not providing due diligence services to needlessly provide certifications to NRSROs.

The Commission intends the definition of "due diligence services" in the Exchange Act-ABS context to cover services provided by entities typically considered to be providers of third-party due diligence services in the securitization market and does not intend it to cover every type of person that might perform some type of diligence in the offering process. As discussed below, the Commission believes that the scope of Section 15E(s)(4)(A) is intended to address third-party due diligence reports obtained by issuers or underwriters from these specialized providers of due diligence services that are relevant to the determination of a credit rating for an Exchange Act-ABS by an NRSRO.

The Commission preliminarily believes, as discussed above, there are four categories of reviews undertaken by entities commonly understood as providers of third-party due diligence services for issuances of RMBS that NRSROs have deemed relevant for determining credit ratings for such Exchange Act-ABS.[575] Consequently, the proposed definition would identify each of the four categories. In addition, because the Commission's understanding of due diligence services largely is based on such services as applied to pools of mortgage loans, the Commission is proposing a catchall component to the proposed definition.[576] The proposed catchall would be designed to apply to due diligence services used for pools of other asset classes (e.g., commercial loans, corporate loans, student loans, or credit card receivables) to the extent

575 See, e.g., US RMBS Ratings Criteria, Fitch (Dec. 3, 2009), Criteria for Evaluating Independent Third-Party Loan Level Reviews for US RMBS, Moody's (Nov. 24, 2008), Incorporating Third-Party Due Diligence Results Into The U.S. RMBS Rating Process, S&P (Nov. 25, 2008).

576 See proposed paragraph (c)(1)(v) of new Rule 17g-10.

that providers of third-party due diligence services currently provide or in the future begin providing due diligence services with respect to other asset classes and those services, because of the different nature of the assets, do not fall into one of the four other categories.

Under the Commission's proposed definition of "due diligence services," an entity would be deemed to have provided "due diligence services" if it engaged in a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to any one of the five types of activities identified in proposed paragraphs (c)(1)(i) through (v) of new Rule 17g-10 (i.e., the components of the proposed definition would be disjunctive).[577] The first category of "due diligence service" would be identified in proposed paragraph (c)(1)(i) of new Rule 17g-10 as a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to the quality or integrity of the information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets.[578] This type of review could entail comparing the data on loan-tape with the data on the hard-copy documentation in an underlying sampled loan file to verify that the loan-tape data matches and correctly represents the content of the loan file under review.[579] The provider of due diligence services would need to note any differences (exceptions) between the loan-tape data and the information in the loan file. This type of review also could entail verifying that the loan-tape contains all the information about the underlying assets the NRSRO requires for the purpose of determining a credit rating and whether that information is presented in the format required by the NRSRO.[580] For example, some NRSROs may specify items of data ("data fields") about a

577 See proposed paragraphs (c)(1)(i)-(v) of new Rule 17g-10.

578 See proposed paragraphs (c)(1)(i) of new Rule 17g-10.

579 See, e.g., US RMBS Ratings Criteria, Fitch (Dec. 3, 2009).

580 Id.

mortgage loan that must be included on the loan tape for an RMBS such as occupancy status, property type, loan purpose, documentation type, current FICO score of the borrower, combined original loan to value ratio, total debt-to-income ratio, and zip code of the residence.[581]

The second category of "due diligence service" would be identified in proposed paragraph (c)(1)(ii) of new Rule 17g-10 as a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to whether the origination of the assets conformed to stated underwriting or credit extension guidelines, standards, criteria, or other requirements.[582] This type of review could entail reviewing whether a sampled loan meets the originator's underwriting guidelines or, if not, that the originator provided a reasonable and documented exception to support the decision to make the loan.[583] This type of review also could entail how the originator verified information in a sampled loan underlying an RMBS such as the borrower's occupancy status with respect to the residence (e.g., primary residence, second home, or rental property), the borrower's income, the borrower's assets, and the borrower's employment status.[584]

The third category of "due diligence service" would be identified in proposed paragraph (c)(1)(iii) of new Rule 17g-10 as a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to the value of collateral securing such assets.[585] This type of review could entail analyzing how the originator verified the value of the asset. For

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581 See, e.g., Incorporating Third-Party Due Diligence Results Into The U.S. RMBS Rating Process, S&P (Nov. 25, 2008).

582 See proposed paragraphs (c)(1)(ii) of new Rule 17g-10.

583 See, e.g., Criteria for Evaluating Independent Third-Party Loan Level Reviews for US RMBS, Moody's (Nov. 24, 2008).

584 See, e.g., Incorporating Third-Party Due Diligence Results Into The U.S. RMBS Rating Process, S&P (Nov. 25, 2008).

585 See proposed paragraphs (c)(1)(iii) of new Rule 17g-10.

example, for an RMBS, an NRSRO might require that the review consider the quality of the appraiser of the property and the quality of the appraisal.[586] This could include reviewing whether the appraiser used a valuation model.[587] It also could require the provider of third-party due diligence services to separately use a valuation model if the reviewer believes that the original appraised value of the property is less than the value presented by the originator.[588]

The fourth category of "due diligence service" would be identified in proposed paragraph (c)(1)(iv) of new Rule 17g-10 as a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to whether the originator of the assets complied with federal, state, or local laws or regulations.[589] This type of review could entail – with respect to an RMBS – analyzing legal documentation in a sampled loan file to verify the loan was made in conformance with, for example, with "truth-in-lending" regulations such as Regulation Z.[590]

The fifth category of "due diligence services" – the catchall – would be identified in proposed paragraph (c)(1)(v) of new Rule 17g-10 as a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to any other factor or characteristic of such assets that would be material to the likelihood that the issuer of the Exchange Act-ABS will pay interest and principal according to its terms and conditions.[591] The Commission preliminarily believes that findings relevant to whether the issuer of the Exchange Act-ABS will pay interest and principal according to its terms and conditions (i.e., not default)

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586 See, e.g., Criteria for Evaluating Independent Third-Party Loan Level Reviews for US RMBS, Moody's (Nov. 24, 2008).

587 Id.

588 Id.

589 See proposed paragraphs (c)(1)(iv) of new Rule 17g-10.

590 See 12 CFR 226.1 et seq.

591 See proposed paragraphs (c)(1)(v) of new Rule 17g-10.

would be relevant to determining a credit rating given that the statutory definition of "credit rating" is "an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments."[592] The Commission also preliminarily believes that reviews of the assets underlying an Exchange Act-ABS that are designed to generate findings that would not be relevant to determining a credit rating would be outside the scope of proposed catchall definition and, therefore, outside the scope of Section 15E(s)(4)(B) of the Exchange Act and Rule 17g-10.[593]

Proposed paragraph (c)(2) of new Rule 17g-10 would define the term "issuer" as including a sponsor, as defined in 17 CFR 229.1011, or depositor, as defined in 17 CFR 229.1011, that participates in the issuance of an Exchange Act-ABS.[594] The Commission preliminarily believes this definition is necessary because the requirements of Section 15E(s)(4)(B) of the Exchange Act are triggered, among other things, when third-party due diligence services are employed by an "issuer."[595] The term "issuer" could be interpreted by entities subject to Section 15E(s)(4)(B) of the Exchange Act and new Rule 17g-10 as meaning the legal entity issuing the Exchange Act-ABS. However, the issuer of an Exchange Act-ABS typically is a passive entity such as a statutory trust. Consequently, a sponsor initiates an Exchange Act-ABS transaction by selling or pledging to a specially created issuing entity a group of financial assets that the sponsor either has originated itself or has purchased in the

592 See 15 U.S.C. 78c(60).

593 See 15 U.S.C. 78o-7(s)(4)(B) and proposed new Rule 17g-10.

594 See proposed paragraph (c)(2) of new Rule 17g-10. The Commission interprets the term "issuer" in Section 15G(a)(3)(A) of the Exchange Act to refer to the depositor of an asset-backed security. This treatment is consistent with the Commission's historical regulatory approach to that term, including the Securities Act and the rules promulgated under the Securities Act and the Exchange Act. See, e.g., 17 CFR 230.191 and 17 CFR 240.3b–19.

595 See 15 U.S.C. 78o-7(s)(4)(B).

secondary market. In some instances, the transfer of assets is a two-step process: the financial assets are transferred by the sponsor first to an intermediate entity, the depositor, and then the depositor transfers the assets to the issuing entity for the particular transaction. Because the issuer is passive, the sponsor, depositor, or underwriter would be more likely to employ a provider of third-party due diligence services. Consequently, if the term "issuer" were narrowly interpreted to mean the passive entity, the objectives of Section 15E(s)(4)(B) of the Exchange Act potentially could be undermined in that the requirement to make the disclosure would not be triggered.

The Commission is proposing to define the terms "originator" and "securitizer" in proposed paragraphs (c)(3) and (c)(4), respectively, of new Rule 17g-10 because the proposed definition of "due diligence services" in proposed paragraph (c)(1) would use those terms.[596] The Commission preliminarily believes defining these terms would provide greater clarity as to the proposed meaning of "due diligence services." Moreover, Section 941 of the Dodd-Frank Act added new Section 15G of the Exchange Act.[597] Section 15G(a) contains definitions of "originator" and "securitizer" to be used for the purposes of that section.[598] Consequently, there are existing definitions the Commission can utilize for the purposes of new Rule 17g-10. For these reasons, proposed paragraph (c)(3) of new Rule 17g-10 would provide that the term "originator" has the same meaning as in Section 15G of the Exchange Act (15 U.S.C. 78o-9).[599]

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596 See proposed paragraphs (c)(3) and (c)(4) of new Rule 17g-10; see also proposed paragraphs (c)(1)(i) and (iv) using the term "originator" and proposed paragraph (c)(1)(i) using the term "securitizer."

597 See Pub. L. No. 111-203 § 941 and 15 U.S.C. 78o-9.

598 See 15 U.S.C. 78o-9(a)(3) and (4).

599 See proposed paragraph (c)(3) of new Rule 17g-10. Section 15G(a)(4) of the Exchange Act defines the term "originator" to mean "a person who—(A) through the extension of credit or otherwise, creates a financial asset that collateralizes and asset-backed security;

Similarly, proposed paragraph (c)(4) of new Rule 17g-10 would provide that the term "securitizer" has the same meaning as in Section 15G of the Exchange Act (15 U.S.C. 78o-9).[600]

Request for Comment

The Commission generally requests comment on all aspects of proposed new Rule 17g-10. The Commission also seeks comment on the following:

1. The Commission understands that "provider of third-party due diligence services" is a phrase used as a term of art in the securitization market, and the proposed rules are intended to apply to those entities that are commonly identified by that term. Would the proposed definition of "due diligence services" provide sufficient guidance to those entities providing due diligence services as to when the requirements of the self-executing provision in Section 15E(s)(4)(B) and proposed new Rule 17g-10 would apply? How could the proposal be modified to provide clearer guidance?
2. Should, as proposed, the definition of "due diligence services" apply to Exchange Act-ABS only or should it apply more broadly to structured finance products? If it should apply more broadly, what types of structured finance products that are not Exchange Act-ABS should the definition include within its scope? In addition, are providers of third-party due diligence services used with respect to these types of structured finance products? If so, explain how the results of those services are relevant to the determination of a credit rating?

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and (B) sells an asset directly or indirectly to a securitizer." See 15 U.S.C. 78o-9(a)(4).

600 See proposed paragraph (c)(4) of new Rule 17g-10. Section 15G(a)(3) of the Exchange Act defines the term "securitizer" to mean: "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." See 15 U.S.C. 78o-9(a)(3).

3. Does the first category of "due diligence service" identified in proposed paragraph (c)(1)(i) of new Rule 17g-10 (i.e., a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to the quality or integrity of the information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets) appropriately describe a form of due diligence service for Exchange Act-ABS that is provided to issuers or underwriters by a provider of third-party due diligence services? For example, is this component of the definition too broad or narrow? If so, how should this component of the definition be refined? Alternatively, should it be omitted from the definition as reflecting activity that is not a third-party due diligence service?
4. Does the second category of "due diligence service" identified in proposed paragraph (c)(1)(ii) of new Rule 17g-10 (i.e., a review of the assets underlying Exchange Act-ABS for the purpose of making findings with respect to whether the origination of the assets conformed to underwriting or credit extension guidelines, standards, criteria or other requirements) appropriately describe a form of due diligence service for Exchange Act-ABS that is provided to issuers or underwriters by a provider of third-party due diligence services? For example, is this component of the definition too broad or narrow? If so, how should this component of the definition be refined? Alternatively, should it be omitted from the definition as reflecting activity that is not a third-party due diligence service?
5. Does the third category of "due diligence service" identified in paragraph (c)(1)(iii) of new Rule 17g-10 (i.e., a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to the value of collateral securing such assets)

appropriately describe a form of due diligence service for Exchange Act-ABS that is provided to issuers or underwriters by a provider of third-party due diligence services? For example, is this component of the definition too broad or narrow? If so, how should this component of the definition be refined? Alternatively, should it be omitted from the definition as reflecting activity that is not a third-party due diligence service?

6. Does the fourth category of "due diligence service" identified in paragraph (c)(1)(iv) of new Rule 17g-10 (i.e., a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to whether the originator of the assets complied with federal, state or local laws or regulations) appropriately describe a form of due diligence service for Exchange Act-ABS that is provided to issuers or underwriters by a provider of third-party due diligence services? For example, is this component of the definition too broad or narrow? If so, how should this component of the definition be refined? Alternatively, should it be omitted from the definition as reflecting activity that is not a third-party due diligence service?

7. Would the catchall component of the definition of "due diligence services" identified in proposed paragraph (c)(1)(v) of new Rule 17g-10 (i.e., a review of the assets underlying an Exchange Act-ABS for the purpose of making findings with respect to any other factor or characteristic of such assets that would be material to the likelihood that the Exchange Act-ABS will pay interest and principal according to its terms and conditions) adequately capture existing or future third-party due diligence services not identified in proposed paragraphs (c)(1)(i) through (iv) of new Rule 17g-10? For example, is this component of the definition too broad or narrow? If so, how should this component of the definition be refined? Alternatively, should it be omitted from the definition?

8. Are there other types of due diligence services for Exchange Act-ABS provided to issuers or underwriters by a provider of third-party due diligence services that are not identified in the Commission's proposed definition that should be included? For example, would the proposed definitions capture third-party due diligence services provided with respect to an Exchange Act-ABS after it has been issued? If proposed definitions would not capture due diligence services provided post-issuance or any other services commonly understood as third party due services, describe such services and provide suggested rule text for how they could be incorporated into the definition. Also, provide an explanation as to how such services would be relevant to the determination of a credit rating?

9. Would the inclusion of the proposed definition of "issuer" in new Rule 17g-10 identify the types of entities that should trigger the requirements of the proposed rule? For example, is the proposed definition too broad or narrow? If so, how should the proposed definition be refined?

10. Would the inclusion of the proposed definition of "originator" in new Rule 17g-10 identify the types of entities that should trigger the requirements of the proposed rule? For example, is the proposed definition too broad or narrow? If so, how should the proposed the definition be refined?

11. Would the inclusion of the proposed definition of "securitizer" in new Rule 17g-10 identify the types of entities that should trigger the requirements of the proposed rule? For example, is the proposed definition too broad or narrow? If so, how should the proposed the definition be refined?

### 3. Proposed Form ABS Due Diligence-15E

Section 15E(s)(4)(C) of the Exchange Act specifies that the Commission shall establish the appropriate format and content for the written certifications required under Section 15E(s)(4)(B), to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate rating.[601] The Commission is proposing to prescribe the format of the certification in Form ABS Due Diligence-15E.[602] The proposed form would contain five line items identifying information the provider of third-party due diligence services would need to set forth in the form. It also would contain a signature line with a corresponding representation.[603]

Item 1 of proposed Form ABS Due Diligence-15E would elicit the identity and address of the provider of third-party due diligence services.[604] This would notify users of the certification as to which third-party conducted the review described in the certification. Item 2 of proposed Form ABS Due Diligence-15E would elicit the identity and address of the issuer, underwriter, or NRSRO that employed the provider of third-party due diligence services.[605] This would notify users of the certification as to the person that employed the third-party to conduct the review described in the certification.

Item 3 of proposed Form ABS Due Diligence-15E would instruct the provider of third-party due diligence services to identify each NRSRO whose published criteria for performing

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601 See 15 U.S.C. 78o-7(s)(4)(C).

602 See proposed new Rule 17 CFR 249b.400 and proposed Form ABS Due Diligence-15E.

603 Id.

604 See Item 1 to proposed Form ABS Due Diligence-15E.

605 See Item 2 to proposed Form ABS Due Diligence-15E.

due diligence the third-party satisfied in performing the due diligence review.[606] As noted above, the NRSROs most active in rating RMBS have incorporated into their procedures and methodologies for determining RMBS credit ratings minimum steps a provider of third-party due diligence services must take in conducting due diligence.[607] Consequently, the instructions for Item 3 would provide that if the manner and scope of the due diligence provided by the third-party satisfied the criteria for due diligence published by an NRSRO, the third party should identify the NRSRO and the title and date of the published criteria in a table provided on the form.[608] The table and instructions would permit the identification of more than one NRSRO.[609] This would allow the third-party to reflect in a single form that it conducted due diligence services in a manner that satisfied the due diligence requirements of multiple NRSROs. As such, Item 3 would be designed to elicit a representation from the provider of the third-party due diligence services that it satisfied a given NRSRO's published due diligence standards.

Items 4 and 5 of proposed Form ABS Due Diligence-15E would require the provider of the third-party due diligence services to describe, respectively: (1) the scope and manner of the due diligence performed; and (2) the findings and conclusions resulting from the review. The instructions for Items 4 and 5 would require the summaries to be provided in attachments to the form, which would be considered part of the form.

As discussed above in Section II.H.1 of this release, the Commission is proposing to implement Section 15E(s)(4)(A) of the Exchange Act by requiring the issuer or underwriter of an

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606 See Item 3 to proposed Form ABS Due Diligence 15E.

607 See, e.g., US RMBS Ratings Criteria, Fitch (Dec. 3, 2009) Criteria for Evaluating Independent Third-Party Loan Level Reviews for US RMBS, Moody's (Nov. 24, 2008) Incorporating Third-Party Due Diligence Results Into The U.S. RMBS Rating Process, S&P (Nov. 25, 2008).

608 Id.

609 Id.

Exchange Act-ABS to disclose the findings and conclusions of a provider of third-party due diligence services by furnishing Form ABS-15G on EDGAR pursuant to proposed Rule 15Ga-2.[610] Alternatively, the issuer or underwriter would be permitted to obtain a representation from each NRSRO engaged to determine a credit rating for the Exchange Act-ABS that the NRSRO will publicly disclose the findings and conclusions of the provider of third-party due diligence services in the form that would need to be published pursuant to proposed new paragraph (a)(1) of Rule 17g-7. In addition, as discussed above in Section II.G.3 of this release, proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7 would implement Section 15E(s)(3)(A)(v) of the Exchange Act by requiring an NRSRO to disclose in the form whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third-party.[611] The Commission preliminarily believes that requiring a provider of third-party due diligence services to summarize in Items 4 and 5 of Form ABS Due Diligence-15E the manner and scope of the due diligence performed and the findings and conclusions resulting from the due diligence would facilitate these other requirements.[612] For example, the NRSRO could use the summaries to make the disclosures in the form generated pursuant to proposed new paragraph (a) of Rule 17g-7. In addition, the Commission preliminarily believes that the disclosures would be useful to investors and other users of credit ratings (as noted above in Section II.G.5, an NRSRO would be required to disclose the

[610] 15 U.S.C. 78o-7(s)(4)(A), proposed new Rule 15Ga-2, and proposed amendments to Form ABS-15G.

[611] See 15 U.S.C. 78o-7(s)(3)(A)(v) and proposed new paragraph (a)(1)(ii)(F) of Rule 17g-7.

[612] See Items 4 and 5 of proposed Form ABS Due Diligence-15E.

certification with the publication of a credit rating pursuant to proposed new paragraph (a)(2) of Rule 17g-7).

To this end, the Commission proposes that Item 4 require the provider of third-party due diligence services to describe the steps taken in performing the due diligence.[613] The instructions would require the third-party to provide this description regardless of whether the third-party represented in Item 3 of the form that its review satisfied published criteria of an NRSRO. In other words, the third-party would not be able to simply rely on a cross-reference to the NRSRO's published criteria to explain the work completed in performing the due diligence. Consequently, the instructions to Item 4 would require the third-party to describe the scope and manner of the due diligence services provided in connection with the review of assets that is sufficiently detailed to provide an understanding of the steps taken in performing the review. The instructions further would require that the third-party include in the description: (1) the type of assets that were reviewed; (2) the sample size of the assets reviewed; (3) how the sample size was determined and, if applicable, computed; (4) whether the quality or integrity of information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets was reviewed and, if so, how the review was conducted; (5) whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines; (6) whether the value of collateral securing such assets was reviewed and, if so, how the review was conducted; (7) whether the compliance of the originator of the assets with federal, state and local laws and regulations was reviewed and, if so, how the review was conducted; and (8) any other type of review conducted with respect to the assets. In other words, the proposed instructions

613 See Item 4 of proposed Form ABS Due Diligence-15E.

would parallel the Commission's proposed definition of "due diligence services" in paragraph (c)(1) of proposed new Rule 17g-10.[614]

As discussed above, the information required by the instructions would provide the NRSRO and investors and users of credit ratings of the NRSRO with a description of the nature of the due diligence performed along with the publication of the credit rating and the form that would be required under proposed new paragraph (a)(1) of Rule 17g-7.[615] The information also would allow the NRSRO and users of credit ratings to compare whether the provider of third-party due diligence services, based on its description, appeared to satisfy published criteria of the NRSRO if such a claim was made in Item 3. Finally, if no criteria had been published for the type of Exchange Act-ABS or no claim to satisfying criteria was made in Item 3, the description would be the sole basis of understanding the due diligence performed.

Item 5 of proposed Form ABS Due Diligence-15E would require the provider of third-party due diligence services to summarize the findings and conclusions resulting from the due diligence review.[616] Specifically, the instructions to Item 5 would require the third-party to provide a summary of the findings and conclusions that resulted from the due diligence services that is sufficiently detailed to provide an understanding of the findings and conclusions that were conveyed to the person identified in Item 2 (i.e., conveyed to the issuer, underwriter, or NRSRO that employed the third-party to perform due diligence services). As discussed above, the reasons for proposing the requirement to provide such a summary are the same as for Item 4 of Form ABS Due Diligence-15E.

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614 Compare Item 4 of proposed Form ABS Due Diligence 15E, with paragraph (c)(1) of proposed new Rule 17g-10.

615 See proposed new paragraph (a) of Rule 17g-7.

616 See Item 5 of proposed Form ABS Due Diligence 15E.

Finally, the individual executing Form ABS Due Diligence-15E on behalf of a provider of third-party due diligence services would need to make two representations.[617] First, the individual would need to represent that he or she has executed the Form on behalf of, and on the authority of, the third-party. Second, the individual would need to represent that the third-party conducted a thorough review in performing the due diligence described in Item 4 attached to the Form and that the information and statements contained in the Form, including Items 4 and 5 attached to the Form, which are part of the Form, are accurate in all significant respects. The Commission is proposing that this representation be made to implement the provision of Section 15E(s)(4)(C) of the Exchange Act, which provides that the Commission shall establish the appropriate format and content of the written certifications "to ensure that providers of due diligence services have conducted a <u>thorough review</u> of data, documentation, and other relevant information necessary for [an NRSRO] to provide an accurate rating (emphasis added)."[618]

<u>Request for Comment</u>

The Commission generally requests comment on all aspects of proposed new Form ABS Due Diligence-15E. The Commission also seeks comment on the following:

1. Would the proposed format of proposed Form ABS Due Diligence-15E appropriately achieve the objectives of Section 15E(s)(4)(C) of the Exchange Act? How could the format be modified to better achieve these objectives?
2. Should proposed Form ABS Due Diligence-15E be more prescriptive in terms of the steps a provider of third-party due diligence services would need to take in performing the review? For example, should the form specify the minimum sample size a provider of third-party due diligence services must perform on the assets underlying the Exchange

617 <u>See</u> "Certification" of proposed Form ABS Due Diligence-15E.

618 <u>See</u> 15 U.S.C. 78o-7(s)(4)(C).

Act-ABS? If so, should the sample size be the same across all asset classes and within asset classes? For example, with respect to RMBS, the scope of due diligence could be based on the type of mortgage loans (prime, Alt-A, or sub-prime), the quality of the originator of the loans, the level of documentation provided with the loans or other characteristics. Moreover, the scope of due diligence required for a CMBS could involve reviewing every pool asset (rather than a sample), since the number of underlying loans is much less than in an RMBS and, therefore, the default of one loan would have a greater impact than the default of a loan underlying an RMBS. Moreover, the scope of due diligence required by an NRSRO for an Exchange Act-ABS where the asset pool composition turns over rapidly because it contains revolving assets, such as credit card receivables or dealer floor-plan receivables, could involve different sampling techniques. How would the Commission account for these variables in prescribing minimum sample sizes or other procedures that would need to be undertaken by a provider of third-party due diligence services? What benefits and costs could result from being more prescriptive? Are there practical issues to imposing a more prescriptive approach? If so, describe these issues.

3. Would the information disclosed in Item 3 of proposed new Form ABS Due Diligence-15E identifying each NRSRO whose published criteria were satisfied by the provider of third-party due diligence services be useful to the NRSRO producing a credit rating for the Exchange Act-ABS? If not, how could the proposed instructions for Item 3 be modified to make it more useful to NRSROs? Are there practical issues to imposing a more prescriptive approach? If so, describe these issues.

4. Would the summary provided in proposed Item 4 of new Form ABS Due Diligence-15E about the scope and manner of the due diligence services provided in connection with the review of assets be useful to investors, other users of credit ratings, and NRSROs producing a credit rating for the asset-backed security? If not, how could the proposed instructions for Item 4 be modified to make it more useful? Are there practical issues to imposing a more prescriptive approach? If so, describe these issues.
5. Would the summary provided in proposed Item 5 of new Form ABS Due Diligence-15E about the findings and conclusions that resulted from the due diligence services be useful to investors, other users of credit ratings, and NRSROs producing a credit rating for the asset-backed security? If not, how could the proposed instructions for Item 5 be modified to make it more useful? Are there practical issues to imposing a more prescriptive approach? If so, describe these issues.

## I. STANDARDS OF TRAINING, EXPERIENCE, AND COMPETENCE

Section 936 of the Dodd-Frank Act provides that the Commission shall issue rules that are reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings: (1) meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates[619] and (2) is tested for knowledge of the credit rating process.[620] The Commission proposes to implement Section 936 by proposing new Rule 17g-9 and amending Rule 17g-2.[621]

### 1. Proposed New Rule 17g-9

619 See Pub. L. No. 111-203 § 936(1).

620 See Pub. L. No. 111-203 § 936(2).

621 See proposed new Rule 17g-9 and proposed new paragraph (b)(15) of Rule 17g-2.

The Commission proposes to implement Section 936 of the Dodd-Frank through new Rule 17g-9.[622] As proposed, new Rule 17g-9 would have three paragraphs: (a), (b) and (c).[623] Proposed paragraph (a) would contain a requirement that an NRSRO design and administer standards of training, experience, and competence.[624] Proposed paragraph (b) would identify factors an NRSRO would need to consider in designing the standards.[625] Proposed paragraph (c) would prescribe two specific requirements that would need to be incorporated into an NRSRO's standards.[626]

### a. Proposed Paragraph (a)

Proposed paragraph (a) of new Rule 17g-9 would require an NRSRO to establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings that are reasonably designed to achieve the objective that such individuals produce accurate credit ratings in the classes and subclasses of credit ratings for which the NRSRO is registered.[627] Consequently, the provision, as proposed, would require the NRSRO to design its own standards.[628] The Commission preliminarily believes this approach would be appropriate because of the varying procedures and methodologies used by NRSROs to determine credit ratings. The proposed requirement would provide flexibility to allow each NRSRO to customize the standards according to its unique

622 See proposed new Rule 17g-9. This rule, if adopted, would be codified at 17 CFR 240.17g-9.

623 See proposed paragraphs (a), (b), and (c) of new Rule 17g-9.

624 See proposed paragraph (a) of new Rule 17g-9.

625 See proposed paragraph (b) of new Rule 17g-9.

626 See proposed paragraph (c) of new Rule 17g-9.

627 See proposed paragraph (a) of new Rule 17g-9.

628 Id.

procedures and methodologies for determining credit ratings and size. For example, the standards established by an NRSRO with hundreds or thousands of credit analysts that produce tens of thousands of credit ratings across a wide range of asset classes may need to be different than the standards of a small NRSRO with only a handful of credit analysts that focus on a particular class of credit ratings.

At the same time, Section 936(1) provides that the Commission's rules must be reasonably designed to ensure that any person employed by an NRRSRO to perform credit ratings meets standards of training, experience, and competence <u>necessary to produce accurate ratings</u> for the categories of issuers whose securities the person rates.[629] Accordingly, while the Commission preliminarily believes that the rule should allow flexibility in terms of the design of the standards, the Commission also preliminarily believes that to appropriately implement Section 936(1) the rule should require that the standards have a common objective. Therefore, proposed paragraph (a) of new Rule 17g-9 would require that the standards, as established, must be reasonably designed to achieve the objective that individuals employed by the NRSRO to determine credit ratings produce accurate credit ratings in the classes of credit ratings for which the NRSRO is registered.

This approach of identifying an objective – the production of accurate ratings – and imposing a requirement that the standards be reasonably designed to achieve the objective parallels Sections 15E(g) and (h) of the Exchange Act, among other provisions in the securities laws.[630] For example, Section 15E(g) of the Exchange Act contains a self-executing requirement that each NRSRO shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such NRSRO, to

[629] <u>See</u> Pub. L. No. 111-203 § 936(1).

[630] <u>See</u> 15 U.S.C. 78o-7(g) and (h).

prevent the misuse in violation of the Exchange Act, or the rules or regulations thereunder, of material, nonpublic information by such NRSRO or any person associated with such NRSRO.[631] Similarly, Section 15E(h) contains a self-executing requirement that each NRSRO shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such NRSRO and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business.[632]

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (a) of new Rule 17g-9. The Commission also seeks comment on the following:

1. Would the approach in paragraph (a) of new Rule 17g-9 (i.e., identifying an objective for the standards and requiring the NRSRO to design its own standards to achieve that objective) appropriately implement Section 936 of the Dodd-Frank Act, particularly when taken together with the provisions of proposed paragraphs (b) and (c) of new Rule 17g-9 discussed below? If not, should the Commission specifically prescribe the requirements of the standards to establish consistent industry-wide standards? If so, would it be practical to prescribe consistent industry-wide standards applicable to each NRSRO? Commenters who believe such an approach would be feasible and appropriate should identify such a standard and provide suggested rule text.
2. Would the objective identified in proposed paragraph (a) of new Rule 17g-9 (i.e., standards of training, experience, and competence that are reasonably designed to achieve the objective that such credit analysts produce accurate credit ratings) be appropriate?

631 See 15 U.S.C. 78o-7(g).

632 See 15 U.S.C. 78o-7(h).

Would it establish an objective that could be achieved? Would it implement the goal of Section 936 of the Dodd-Frank Act? Commenters who believe that the proposed objective is not appropriate should explain why and provide suggested rule text to modify the objective.

3. Is the objective – the production of "accurate credit ratings" – assessable? For example, how should the accuracy of credit ratings be measured?
4. Would it be feasible to establish a testing program that has standardized components to review the adequacy of the standards of training, experience, and competence that an NRSRO maintains, enforces, and documents pursuant to proposed paragraph (a) of new Rule 17g-9? If so, what should the components of that testing program be? What would be the advantages and disadvantages of such a program? Are there comparable testing programs used in other contexts that would be relevant in developing such a program?

**b. Proposed Paragraph (b)**

While proposed paragraph (a) of new Rule 17g-9 would provide that the NRSRO must design the standards, proposed paragraph (b) would identify factors the NRSRO must consider when designing the standards.[633] The Commission intends the identified factors to provide guidance to NRSROs about the Commission's expectations for the design of the standards of training, experience, and competence. It also is intended to provide benchmarks that Commission examiners could use to evaluate whether a given NRSRO's standards are reasonably designed to meet the objective set forth in proposed paragraph (a).

Proposed paragraph (b) of new Rule 17g-9 would require the NRSRO to consider each factor in the context of the potentially varying roles of the individuals employed by the NRSRO

[633] See proposed paragraph (b) of new Rule 17g-9.

to determine credit ratings. More specifically, the Commission preliminarily believes that the design of the standards must account for different functions and responsibilities of such individuals as well as the different procedures and methodologies they use to determine credit ratings. The Commission is not proposing that the NRSRO design a standard for each individual. Rather, the Commission preliminarily believes that the standards, particularly of a large NRSRO with hundreds or thousands of credit analysts, should account for groups of individuals who are not similarly situated, for example, in terms of years of experience, education level, responsibility, and complexity of the procedures and methodologies they use to determine credit ratings.

The first factor – identified in proposed paragraph (b)(1) of Rule 17g-9 – would require the NRSRO, when establishing the standards of training, experience, and competence, to consider if the credit rating procedures and methodologies used by the individual involve qualitative analysis, the knowledge necessary to effectively evaluate and process the data relevant to the creditworthiness of the obligor being rated or the issuer of the securities or money market instruments being rated.[634] The Commission intends proposed paragraph (b)(1) to require the NRSRO to consider the fact that qualitative analysis relies, in large part, on identifying and assimilating relevant information about an obligor or issuer and making judgments on how that information impacts the creditworthiness of the obligor or the issuer.

The second factor – identified in proposed paragraph (b)(2) of Rule 17g-9 – would require the NRSRO, when establishing the standards of training, experience, and competence, to consider if the credit rating procedures and methodologies used by the individual involve quantitative analysis, the technical expertise necessary to understand any models and model

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634 See proposed paragraph (b)(1) of new Rule 17g-9.

inputs that are a part of the procedures and methodologies.[635] The Commission intends proposed paragraph (b)(2) to require the NRSRO to consider the fact that quantitative analysis relies, in large part, on mathematical techniques and, consequently, credit analysts using quantitative models would need to have relevant technical expertise.

The third factor – identified in proposed paragraph (b)(3) of Rule 17g-9 – would require the NRSRO, when establishing the standards of training, experience, and competence, to consider the classes and subclasses of credit ratings for which each individual participates in determining credit ratings and the factors relevant to such classes and subclasses, including the geographic location, sector, industry, regulatory and legal framework, and underlying assets, applicable to the obligors or issuers in the classes and subclasses.[636] The Commission intends proposed paragraph (b)(3) to require the NRSRO to consider the fact that different types of obligors and issuers have unique characteristics that may be relevant to the creditworthiness of the obligor or the issuer. For example, the knowledge and competence necessary to rate an operating company is different from that necessary to rate an asset-backed security or a municipal security. Moreover, there may be differences within classes of credit ratings. For example, rating an RMBS requires different knowledge than rating a CMBS, and rating a company in the oil industry requires different knowledge than rating a company in the telecommunications industry.

The fourth factor – identified in proposed paragraph (b)(4) of Rule 17g-9 – would require the NRSRO to consider, when establishing the standards of training, experience, and competence, the complexity of the obligors, securities, or money market instruments being rated

[635] See proposed paragraph (b)(2) of new Rule 17g-9.

[636] See proposed paragraph (b)(3) of new Rule 17g-9.

by the individual.[637] The Commission intends proposed paragraph (b)(4) to require the NRSRO to consider the fact that obligors and securities it rates may vary widely in terms of complexity. For example, more experience and competence may be necessary to rate a synthetic CDO as opposed to a typical RMBS or a global financial company as opposed to a community bank.

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (b) of new Rule 17g-9. The Commission also seeks comment on the following:

1. Are there any other factors in addition to, or as an alternative to, the four factors identified in paragraphs (b)(1) through (4) an NRSRO should consider when establishing standards of training, experience, and competence? For example, should the proposed rule require an NRSRO to consider the number of initial credit ratings the individual is expected to participate in determining annually and the number of credit ratings the individual is expected to participate in monitoring annually? If so, how should these factors be taken into consideration? Identify any additional or alternative factors and provide suggested rule text.
2. Should the factor identified in proposed paragraph (b)(1) of Rule 17g-9 (i.e., if the credit rating procedures and methodologies used by the individual involve qualitative analysis, the knowledge necessary to effectively evaluate and process the data relevant to the creditworthiness of the obligor being rated or the issuer of the securities or money market instruments being rated) be considered when the NRSRO designs its standards of training, experience, and competence for the individuals it employs to determine credit ratings? If not, should proposed paragraph (b)(1) be modified to provide better guidance

637 See proposed paragraph (b)(4) of new Rule 17g-9.

for designing the standards? If so, how should it be modified? Alternatively, should it be omitted from the rule? If so, explain why.

3. Should the factor identified in proposed paragraph (b)(2) of Rule 17g-9 (i.e., if the credit rating procedures and methodologies used by the individual involve quantitative analysis, the technical expertise necessary to understand any models and model inputs that are a part of the procedures and methodologies) be considered when the NRSRO designs its standards of training, experience, and competence for the individuals it employs to determine credit ratings? If not, should proposed paragraph (b)(2) be modified to provide better guidance for designing the standards? If so, how should it be modified? Alternatively, should it be omitted from the rule? If so, explain why.
4. Should the factor identified in proposed paragraph (b)(3) of Rule 17g-9 (i.e., the classes and subclasses of credit ratings for which the individual participates in determining credit ratings and the factors relevant to such classes and subclasses, including the geographic location, sector, industry, regulatory and legal framework, and underlying assets, applicable to the obligors or issuers in the classes and subclasses) be considered when the NRSRO designs its standards of training, experience, and competence for the individuals it employs to determine credit ratings? If not, should proposed paragraph (b)(3) be modified to provide better guidance for designing the standards? If so, how should it be modified? Alternatively, should it be omitted from the rule? If so, explain why.
5. Should the factor identified in proposed paragraph (b)(4) of Rule 17g-9 (i.e., the complexity of the obligors, securities, or money market instruments being rated by the individuals) be considered when the NRSRO designs its standards of training, experience, and competence for the individuals it employs to determine credit ratings? If

not, should proposed paragraph (b)(4) be modified to provide better guidance for designing the standards? If so, how should it be modified? Alternatively, should it be omitted from the rule? If so, explain why.

### c. Proposed Paragraph (c)

Proposed paragraph (c) of new Rule 17g-9 would prescribe two requirements that an NRSRO must incorporate into its standards of training, experience, and competence.[638] The first requirement would be prescribed in proposed paragraph (c)(1) of new Rule 17g-9.[639] This paragraph would provide that the standards of training, experience, and competence must include a requirement for periodic testing of the individuals employed by the NRSRO to determine credit ratings on their knowledge of the procedures and methodologies used by the NRSRO to determine credit ratings in the classes or subclasses of credit ratings for which the individual participates in determining credit ratings.[640] The Commission is proposing this requirement to implement Section 936(2) of the Dodd-Frank Act, which provides that the Commission shall issue rules that are reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings is tested for knowledge of the credit rating process.[641] The Commission preliminarily believes that the frequency and manner of testing should be established by the NRSRO. For example, the frequency and manner of testing may depend on whether an NRSRO employs a large number of analysts with varying levels of experience to rate a wide range of obligors, securities, and money market instruments. In this case, testing may need to be more frequent, particularly with respect to more junior analysts. On the other hand, an NRSRO that

638 See proposed paragraphs (c)(1) and (2) of new Rule 17g-9.

639 See proposed paragraph (c)(1) of new Rule 17g-9.

640 Id.

641 See Pub. L. No. 111-203 § 936(2).

employs few analysts who focus on rating a specific type of obligor, security, or money market instrument may need less frequent testing, particularly if the analysts are experienced. However, the Commission notes that the testing program – as with all aspects of the standards – would need to be reasonably designed to achieve the objective that the credit analysts produce accurate credit ratings in the classes of credit ratings for which the NRSRO is registered.[642] Consequently, an NRSRO would need to establish a training schedule that is consistent with achieving this objective.

The second requirement would be prescribed in proposed paragraph (c)(2) of new Rule 17g-9.[643] This paragraph would provide that the standards of training, experience, and competence must include a requirement that at least one individual with three years or more experience in performing credit analysis participates in the determination of a credit rating.[644] The Commission preliminarily believes three years of experience is appropriate because, among other things, being in business as a credit rating agency for three years was a minimum prerequisite to being treated as an NRSRO under the Rating Agency Act of 2006.[645] Specifically, prior to being amended by the Dodd-Frank Act, the first prong of the definition of

642 See proposed paragraph (a) of new Rule 17g-9.

643 See proposed paragraph (c)(2) of new Rule 17g-9.

644 Id.

645 See Section 3(a)(61)(A) of the Exchange Act, as added by Section 3(a) of the Rating Agency Act of 2006. See Pub. L. No. 109-291 § 3. Section 932(b) of the Dodd-Frank Act struck subparagraph (A) of Section 3(a)(61) of the Exchange Act and re-designated paragraph (B) as paragraph (A). See Pub. L. No. 111-203 § 932(b). While the Dodd-Frank Act eliminated the "three-year" prong from the definition of NRSRO, the Commission does not believe this evidences a view that the credit analysts who work for a credit rating agency need not have any experience. In fact, as noted above, Section 936(1) of the Dodd-Frank Act, among other things, provides that the Commission shall issue rules that are reasonably designed to ensure that any person employed by an NRRSRO to perform credit ratings meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates. See Pub. L. No. 111-203 § 936(1).

"nationally recognized statistical rating organization," provided that the entity "has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under Section 15E."[646] Moreover, Section 15E(a)(1)(B)(ix) of the Exchange Act requires a credit rating agency applying for registration as an NRSRO to submit certifications from qualified institutional buyers ("QIBs") as specified in Section 15E(a)(1)(C) of the Exchange Act.[647] Sections 15E(a)(1)(C)(i) through (iii) of the Exchange Act provide, among other things, that the applicant must furnish certifications from a minimum of 10 QIBs, including certifications from no less than two QIBs for each category of obligor for which the applicant intends to be registered.[648] Section 15E(a)(1)(C)(iv) provides, among other things, that the certification must state that the entity meets the definition of a QIB and has used the credit ratings of the applicant for at least the three years immediately preceding the date of the certification in the subject category or categories.[649]

The Commission considered these former and current provisions of Section 15E of the Exchange Act in developing the proposed three-year requirement in paragraph (c)(2) of new Rule 17g-9. The Commission preliminarily believes that having at least one person participate in the determination of a credit rating who has at least three years experience in performing credit analysis would establish an appropriate baseline requirement that could be implemented by NRSROs without causing them to hire new staff or re-allocate staff resources. For example, in terms of participating in the credit rating, the Commission preliminarily believes an NRSRO's standard could require that at least one person with at least three years experience serve on a

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646 Id.

647 See 15 U.S.C. 78o-7(a)(1)(B)(ix) and 15 U.S.C. 78*o*-7(a)(1)(C).

648 See 15 U.S.C. 78o-7(a)(1)(C)(i)-(iii).

649 See 15 U.S.C. 78o-7(a)(1)(C)(iv).

committee that votes to approve the credit rating or that reviews and approves a credit rating action proposed by a junior analyst. Moreover, the Commission notes that performing credit analysis is not synonymous with determining credit ratings. Many financial institutions have credit risk departments staffed by individuals who analyze the creditworthiness of existing and future counterparties and borrowers. The Commission preliminarily intends that this type of work would qualify a credit analyst to meet the three-year requirement in proposed paragraph (c)(2) of new Rule 17g-9. Consequently, if an NRSRO employed an individual who performed credit analysis for a financial institution for more than three years, that individual would qualify for purposes of the proposed "three-year" requirement.

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (c) of new Rule 17g-9. The Commission also seeks comment on the following:

1. Would proposed paragraph (c)(1) of new Rule 17g-9 (which would provide that the standards of training, experience, and competence must include a requirement for periodic testing of the individuals employed by the NRSRO to determine credit ratings on their knowledge of the procedures and methodologies used by the NRSRO to determine credit ratings in the classes and subclasses of credit ratings for which the individual is responsible for determining credit ratings) appropriately implement Section 936(2) of the Dodd-Frank Act? If not, how should proposed paragraph (c)(1) be modified to better achieve the objective of Section 936(2)?
2. Should the Commission prescribe the frequency of the periodic testing that would be mandated under proposed paragraph (c)(1) of new Rule 17g-9? For example, should an NRSRO be required to administer testing every six months, every year, every two years?

3. Would proposed paragraph (c)(2) of new Rule 17g-9 (which would provide that the standards of training, experience, and competence must include a requirement that at least one individual with three years or more experience in performing credit analysis participates in the determination of a credit rating) be an appropriate measure in terms of implementing Section 936 of the Dodd-Frank Act? If not, how should proposed paragraph (c)(2) be modified to better achieve the objective of Section 936? For example, should the Commission establish a different minimum number of years such as 1 or 2 years experience or 4, 5, 6, 7, or some larger number of years? Alternatively, should this proposal be omitted from the rule? If so, explain why?

### 2. Proposed Amendment to Rule 17g-2

For the reasons discussed in Section II.A.2 of this release, the Commission preliminarily believes that the standards of training, experience, and competence an NRSRO would be required, among other things, to document pursuant to proposed paragraph (a) of new Rule 17g-9 should be subject to the recordkeeping requirements of Rule 17g-2.[650] Consequently, the Commission proposes adding new paragraph (b)(15) to Rule 17g-2 to identify the standards of training, experience, and competence the NRSRO must establish, maintain, enforce, and document pursuant to proposed new Rule 17g-9 as a record that must be retained.[651] As a result, the standards would be subject to the record retention and production requirements in paragraphs (c) through (f) of Rule 17g-2.[652]

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650 17 CFR 240.17g-2.

651 See proposed new paragraph (b)(15) to Rule 17g-2; see also Section 17(a)(1) of the Exchange Act, which requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. 15 U.S.C. 78q(a)(1).

652 See 17 CFR 240.17g-2.

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (b)(15) of Rule 17g-2.

## J. UNIVERSAL RATING SYMBOLS

Section 938(a) of the Dodd-Frank Act provides that the Commission shall require, by rule, each NRSRO to establish, maintain, and enforce written policies and procedures that: (1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;[653] (2) clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating;[654] and (3) apply any symbol described in item (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.[655] Section 938(b) of the Dodd-Frank Act provides that nothing in Section 938 shall prohibit an NRSRO from using distinct sets of symbols to denote credit ratings for different types of securities or money market instruments.[656]

The Commission proposes to implement Section 938(a) of the Dodd-Frank Act by proposing paragraph (b) of new Rule 17g-8 and by amending Rule 17g-2.[657]

### 1. Proposed Paragraph (b) of New Rule 17g-8

653 See Pub. L. No. 111-203 § 938(a)(1).

654 See Pub. L. No. 111-203 § 938(a)(2).

655 See Pub. L. No. 111-203 § 938(a)(3).

656 See Pub. L. No. 111-203 § 938(b).

657 See proposed paragraph (b) of Rule new 17g-8 and proposed new paragraph (b)(14) of Rule 17g-2. As discussed earlier, the Commission is proposing that rule requirements specifying policies and procedures be consolidated in new Rule 17g-8.

The Commission preliminarily believes that Section 938(a) of the Dodd-Frank Act is explicit in prescribing the policies and procedures the Commission shall require, by rule, of each NRSRO.[658] Consequently, the Commission proposes that the rule text of proposed paragraph (b) of new Rule 17g-8 mirror the statutory text.

The prefatory text of proposed paragraph (b) of new Rule 17g-8 would provide that an NRSRO must establish, maintain, enforce, and document policies and procedures that are reasonably designed to achieve three objectives, which would be identified in paragraphs (b)(1), (2), and (3).[659] This proposed provision would mirror the prefatory text of Section 938(a) of the Dodd-Frank Act except that the proposed rule text would add the requirement that the NRSRO "document" the policies and procedures.[660] The Commission preliminarily believes it would be appropriate to add a documentation requirement because it would mean that an NRSRO would need to put its policies and procedures into writing. This requirement, coupled with the Commission's proposal discussed next to apply the record retention and production provisions of Rule 17g-2 to the policies and procedures, would be designed to make them more readily available to Commission examiners. In addition, the Commission believes it is a sound practice for any organization to document its policies and procedures to promote better understanding of them among the individuals within the organization and, therefore compliance with such policies and procedures.

Proposed paragraph (b)(1) of new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to assess the probability that an issuer of a security or

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658 See Pub. L. No. 111-203 § 936(a).

659 See prefatory text of proposed paragraph (b) of new Rule 17g-8.

660 Compare prefatory text of Pub. L. No. 111-203 § 938(a), with prefatory text of proposed paragraph (b) of new Rule 17g-8.

money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument.[661] This proposed provision would mirror the text of Section 938(a)(1) of the Dodd-Frank Act.[662] The Commission also notes that Section 15E(s)(3)(B)(ii) of the Exchange Act provides that the Commission's rule requiring an NRSRO to generate a form to disclose information with the publication of a credit rating requires disclosure of information on the content of the credit rating, including: (1) the historical performance of the credit rating; and (2) the expected probability of default and the expected loss in the event of default.[663] As discussed above in Section II.G.3 of this release, the Commission is proposing to implement this requirement in proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7.[664] The Commission preliminarily believes proposed paragraph (b)(1) of new Rule 17g-8 would work in conjunction the requirement in proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7 insomuch as the policies and procedures proposed to be required by the former would assist the NRSRO in making the disclosure proposed to be required in the latter.

Proposed paragraph (b)(2) of new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to clearly define each symbol, number, or score in the rating scale used by the NRSRO to denote a credit rating category and notches within a category for each class and subclass of credit ratings for which the NRSRO is registered and to include such definitions in Exhibit 1 to Form NRSRO.[665] This proposed provision would implement Section

661 See proposed paragraph (b)(1) of new Rule 17g-8.

662 Compare text of Pub. L. No. 111-203 § 938(a)(1), with text of proposed paragraph (b)(1) of new Rule 17g-8.

663 See 15 U.S.C. 78o-7(s)(3)(B)(ii).

664 See proposed new paragraph (a)(1)(ii)(L) of Rule 17g-7.

665 See proposed paragraph (b)(2) of new Rule 17g-8.

938(a)(2) of the Dodd-Frank Act.[666] In addition, it would mirror text in the proposed revisions to the Instructions to Exhibit 1 to Form NRSRO as well as work in conjunction with the requirements in those instructions.[667] As discussed above in Section II.E.1.a of this release, the Commission is proposing to amend the Instructions for Exhibit 1. One of the proposed amendments would require the NRSRO to clearly define in Exhibit 1 the meaning of each symbol, number, or score in the rating scale used by the applicant or NRSRO to denote a credit rating category and notches within a category in any Transition/Default Matrix presented in the Exhibit.[668] Consequently, taken together, the proposals would require an NRSRO to have policies and procedures that clearly define the meaning of each symbol, number, or score used by the NRSRO to denote a credit rating and to disclose those meanings in Exhibit 1 where investors and other users of credit ratings can find them.

Proposed paragraph (b)(3) of new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to apply any symbol, number, or score defined pursuant to paragraph (b)(2) of Rule 17g-8 in a manner that is consistent for all types of obligors, securities, and money market instruments for which the symbol, number, or score is used.[669] This proposed provision would mirror the text of Section 938(a)(3) of the Dodd-Frank Act, except that the proposed rule text would add the term "obligors."[670] The Commission proposes this addition in

666 Compare text of Pub. L. No. 111-203 § 938(a)(2), with text of proposed paragraph (b)(2) of new Rule 17g-8.

667 See Instructions to Exhibit 1 to Form NRSRO.

668 See proposed amendments to Instructions to Exhibit 1 to Form NRSRO.

669 See proposed paragraph (b)(1) of new Rule 17g-8.

670 Compare text of Pub. L. No. 111-203 § 938(a)(3), with text of proposed paragraph (b)(3) of new Rule 17g-8.

order to apply the provisions of proposed paragraph (b)(3) of new Rule 17g-8 to credit ratings of obligors as entities in addition to credit ratings of securities and money market instruments.[671]

Request for Comment

The Commission generally requests comment on all aspects of proposed paragraph (b) of new Rule 17g-8. The Commission also seeks comment on the following:

1. Is proposed paragraph (b)(1) of new Rule 17g-8 sufficiently explicit in terms of the objective that the policies and procedures be reasonably designed to assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument)? If not, what additional detail should the Commission provide in terms of the clarifying the objective?
2. Is proposed paragraph (b)(2) of new Rule 17g-8 sufficiently explicit in terms of the objective that the policies and procedures be reasonably designed to clearly define the meaning of each symbol, number, or score used by the NRSRO to denote a credit rating category and notches within a category in the rating scale for each class and subclass of credit ratings for which the NRSRO is registered and to include such definitions in Exhibit 1 to Form NRSRO? If not, what additional detail should the Commission provide in terms of the clarifying the objectives?
3. Is proposed paragraph (b)(3) of new Rule 17g-8 sufficiently explicit in terms of the objective that the policies and procedures be reasonably designed to apply any symbol, number, or score defined in a manner that is consistent for all types of obligors,

671 See, e.g., the definition of "credit rating" in Section 3(a)(60) of the Exchange Act ("The term 'credit rating' means an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments."). 15 U.S.C. 78o-7(a)(60).

securities, and money market instruments for which the symbol, number, or score is used? If not, what additional detail should the Commission provide in terms of the clarifying the objective?

### 2. Proposed Amendment to Rule 17g-2

For the reasons discussed in Section II.A.2 of this release, the Commission preliminarily believes that the policies and procedures an NRSRO would be required, among other things, to document pursuant to proposed paragraph (b) of new Rule 17g-8 should be subject to the recordkeeping requirements of Rule 17g-2.[672] Consequently, the Commission proposes adding new paragraph (b)(14) to Rule 17g-2 to identify the policies and procedures an NRSRO must establish, maintain, enforce, and document pursuant to proposed paragraph (b) of new Rule 17g-8 as a record that must be retained.[673] As a result, the policies and procedures would be subject to the record retention and production requirements in paragraphs (c) through (f) of Rule 17g-2.[674]

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (b)(14) of Rule 17g-2.

## K. ANNUAL REPORT OF DESIGNATED COMPLIANCE OFFICER

Section 932(a)(5) of the Dodd-Frank Act amended Section 15E(j) of the Exchange Act to re-designate paragraph (j) as paragraph (j)(1) and to add new paragraphs (j)(2) through

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672 17 CFR 240.17g-2.

673 See proposed new paragraph (b)(14) to Rule 17g-2; see also Section 17(a)(1) of the Exchange Act, which requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. 15 U.S.C. 78q(a)(1).

674 See 17 CFR 240.17g-2.

(j)(5).[675] Section 15E(j)(1) of the Exchange Act contains a self-executing provision that an NRSRO designate an individual (the "designated compliance officer") responsible for administering the policies and procedures that are required to be established pursuant to Sections 15E(g) and (h) of the Exchange Act,[676] and for compliance with the securities laws and the rules and regulations thereunder, including those promulgated by the Commission under Section 15E of the Exchange Act.[677] Sections 15E(j)(2) through (4) prescribe self-executing requirements with respect to, among other things, the activities, duties, and compensation of the designated compliance officer.[678]

Section 15E(j)(5)(A) of the Exchange Act requires the designated compliance officer to submit to the NRSRO an annual report on the compliance of the NRSRO with the securities laws and the policies and procedures of the NRSRO that includes: (1) a description of any material changes to the code of ethics and conflict of interest policies of the NRSRO; and (2) a certification that the report is accurate and complete.[679] Section 15E(j)(5)(B) of the Exchange Act provides that the NRSRO shall file the report required pursuant to Section 15E(j)(5)(A) together with the financial report that is required to be submitted to the Commission under Section 15E of the Exchange Act.[680]

Consequently, Section 15E(j)(5)(B) of the Exchange Act contains a self-executing provision requiring the NRSRO to file the annual report of the designated compliance officer "with the financial report that is required to be submitted to the Commission under this

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675 See Pub. L. No. 111-203 § 932(a)(5) and 15 U.S.C. 78o-7(j)(1) though (5).

676 See 15 U.S.C 780-7(g) and (h).

677 See 15 U.S.C. 78o-7(j)(1).

678 See 15 U.S.C. 78o-7(j)(1) though (4).

679 See 15 U.S.C. 78o-7(j)(5)(A).

680 See 15 U.S.C. 78o-7(j)(5)(B).

section."[681] The Commission notes that Section 15E(k) of the Exchange Act provides that each NRSRO shall, on a confidential basis, file with the Commission, at intervals determined by the Commission, such financial statements, certified (if required by the rules or regulations of the Commission) by an independent public accountant, and information concerning its financial condition, as the Commission, by rule may prescribe as necessary or appropriate in the public interest or for the protection of investors.[682] The Commission implemented Section 15E(k) by adopting Rule 17g-3.[683] Therefore, under the self-executing provisions in Section 15E(j)(5)(B) of the Exchange Act, an NRSRO must file the report of the designated compliance officer with the reports required to be submitted pursuant to Rule 17g-3.[684]

As discussed above in Section II.A.3 of this release, Rule 17g-3 requires an NRSRO to furnish five or, in certain cases, six separate reports not more than 90 days after the end of the NRSRO's fiscal year.[685] In order to further clarify the self-executing requirement in Section 15E(j)(5)(B) of the Exchange Act, the Commission is proposing to amend Rule 17g-3 to identify the annual report of the designated compliance officer as one of the reports that must be filed

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681 Id.

682 The Dodd-Frank Act replaced the words "furnish to the Commission" with the words "file with the Commission" in Section 15E(k) of the Exchange Act. See 15 U.S.C. 78o-7(k).

683 See 17 CFR 240.17g-3; see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33590-33593 (June 18, 2007).

684 See 15 U.S.C. 78o-7(j)(5)(B), 15 U.S.C. 78o-7(k), and 17 CFR 240.17g-3.

685 See 17 CFR 240.17g-3(a)(1)-(6). As discussed above in Section II.A.3 of this release, the Commission is proposing that Rule 17g-3 be amended to add a new paragraph (a)(7) to implement Section 15E(c)(3)(B) of the Exchange Act by requiring an NRSRO to file the annual report on the NRSRO's internal control structure with the annual reports. See 15 U.S.C. 78o-7(c)(3)(B).

with the Commission.[686] Specifically, the Commission proposes adding a new paragraph (a)(8) to Rule 17g-3 to identify the report on the compliance of the NRSRO with the securities laws and the policies and procedures of the NRSRO required to be filed with the Commission pursuant to Section 15E(j)(5)(B) of the Exchange Act.[687] New paragraph (a)(8) would provide that the report need not be audited. Furthermore, the Commission preliminarily does not intend to prescribe how the report must be certified because Section 15E(j)(5)(A)(ii) of the Exchange Act already provides that the designated compliance officer must certify that the report is accurate and complete.[688]

Request for Comment

The Commission generally requests comment on all aspects of proposed new paragraph (a)(8) of Rule 17g-3. The Commission also seeks comment on the following:

1. Should an NRSRO be required to attach to the annual report a signed statement by a duly authorized person (e.g., the designated compliance officer) stating explicitly that the person has responsibility for the reports and, to the best knowledge of the person, the reports fairly present, in all material respects, the information contained in the reports? For example, because the designated compliance officer is providing the report to the NRSRO and the NRSRO, in turn, is submitting the report to the Commission, would it be appropriate for the Commission to require an additional certification addressing the submission of the report from the NRSRO to the Commission?

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686 See proposed new paragraph (a)(8) of Rule 17g-3.

687 Id.

688 See 15 U.S.C. 78o-7(j)(5)(A)(ii). Paragraph (b) of Rule 17g-3 provides that the NRSRO must attach to the reports required to be submitted pursuant to Rule 17g-3 a signed statement by a duly authorized person that the person has responsibility for the reports and, to the best knowledge of the person, the reports fairly present, in all material respects, the information contained in the reports. See 17 CFR 240.17g-3(b).

## L. ELECTRONIC SUBMISSION OF FORM NRSRO AND THE RULE 17g-3 ANNUAL REPORTS

An NRSRO currently submits the Form NRSROs required under Rule 17g-1 and the annual reports required under Rule 17g-3 to the Commission in paper form. The Commission proposes amending Rule 17g-1, the Instructions to Form NRSRO, Rule 17g-3, and Regulation S-T to require an NRSRO to use the Commission's EDGAR system to: (1) electronically file or furnish, as applicable, Form NRSRO and the information and documents contained in Exhibits 1 through 9 of Form NRSRO if the submission is made pursuant to paragraph (e), (f) or (g) of Rule 17g-1 (i.e., an update of registration, an annual certification, or a withdrawal from registration, respectively)[689] and (2) electronically file or furnish, as applicable, the annual reports required by Rule 17g-3.[690]

Under this proposal, however, an applicant or NRSRO would continue to submit in paper format Form NRSROs pursuant to paragraphs (a), (b), (c), and (d) of Rule 17g-1 (initial applications for registration, applications to register for an additional class of credit ratings, supplements to an initial application or application to register for an additional class of credit ratings, and withdrawals of initial applications or applications to register for an additional class of credit ratings, respectively).[691] The Commission preliminarily believes that these materials

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689 See 17 CFR 240.17g-1(e), (f), and (g). The electronic submissions of Form NRSRO and Exhibits 1 through 9 of Form NRSRO would be made available to the public immediately upon filing.

690 See 17 CFR 240.17g-3. An NRSRO is not required to make the Rule 17g-3 annual reports publicly available and the reports would not be available to the public on EDGAR. The information collected pursuant to Rule 17g-3 is, and would continue to be, kept confidential to the extent permitted by the Freedom of Information Act ("FIOA"). See 15 U.S.C. 552 et seq.

691 Paragraph (i) of Rule 17g-1 requires an NRSRO to make Form NRSRO and information and documents submitted in Exhibits 1 through 9 publicly available within 10 business days of the Commission order granting an initial application for registration or an application to register for an additional class of credit ratings. 17 CFR 240.17g-1(i). The

are appropriately received in paper form because of the iterative nature of the NRSRO application process. For example, an applicant often will have a number of phone conferences and meetings with the Commission staff during the application process to clarify the information submitted in the application. These interactions may result in applicants informally providing additional information relating to the application and informally amending or augmenting information provided in the Form and its Exhibits. The Commission preliminarily believes paper submissions facilitate this type of iterative process.

In terms of requiring the electronic submission of Form NRSROs submitted pursuant to paragraph (e), (f), or (g) of Rule 17g-1, the Commission notes that one of the primary goals of the EDGAR system is to facilitate the rapid dissemination of financial and business information in connection with filings the Commission receives. Although paragraph (i) of Rule 17g-1 currently requires NRSROs to make the public portions of their current Form NRSROs publicly available within 10 business days after submission to the Commission, the Commission believes having all such information available immediately in one location would make the information more easily available and searchable to investors and other users of credit ratings. Further, the Commission believes submissions to the Commission are more valuable to investors and other users of credit ratings if they are available in electronic format and that adding the Form NRSRO submissions to the EDGAR database would provide a more complete picture for the public. The Commission preliminarily believes that, as a result of the proposals, the EDGAR page of the Commission's Internet website[692] and the NRSRO page of the Commission's Internet website[693]

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initial application for registration contains information and documents the NRSRO is not required to make publicly available. This includes Exhibits 10 through 13 to Form NRSRO, disclosure reporting pages to Form NRSRO, and certifications from QIBs under Section 15E(a)(1)(C) of the Exchange Act (15 U.S.C. 780-7(a)(1)(C)).

692 http://www.sec.gov/investor/pubs/edgarguide.htm

would be a comprehensive source containing most public information submitted to the Commission, as well as other information, related to NRSROs. The Commission preliminarily believes that the electronic submission of Form NRSROs would benefit investors and other users of credit ratings by increasing the efficiency of retrieving and comparing NRSRO public submissions and enabling the investors and other users of credit ratings to access information more quickly. An investor or other user of credit ratings would be able to find and review a Form NRSRO on any computer with an Internet connection by accessing EDGAR data on the Commission's Internet website or through a third party.

In addition, while the Rule 17g-3 annual reports would not be made public through the EDGAR system, having these reports and the Form NRSROs available on EDGAR could assist the Commission in its oversight of NRSROs. For example, Commission examiners could retrieve more easily the Form NRSROs and annual reports of a specific NRSRO to prepare for an examination. Moreover, having these records submitted and stored through the EDGAR system (i.e., in a centralized location) would assist the Commission from a records management perspective by establishing a more automated storage process and creating efficiencies in terms of reducing the volume of paper submissions that must be manually processed and stored.

Moreover, the Commission preliminarily believes that the electronic submission of Form NRSRO and Rule 17g-3 annual reports would benefit NRSROs. For example, NRSROs would avoid the uncertainties, delay, and expense related to the manual delivery of paper submissions. Further, NRSROs would benefit from no longer having to submit multiple paper copies of these forms and reports to the Commission.

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693 www.sec.gov/divisions/marketreg/ratingagency.htm.

As with other entities that make submissions through the EDGAR systems, these submissions would be subject to the provisions of Regulation S-T[694] and the EDGAR Filer Manual. Regulation S-T includes detailed rules concerning mandatory and permissive electronic EDGAR submissions. It also provides that requests for confidential treatment must be made in paper form.[695] The EDGAR Filer Manual contains detailed technical specifications concerning EDGAR submissions. The EDGAR Filer Manual also provides technical guidance concerning how to begin making submissions on EDGAR by submitting Form ID to obtain a CIK number[696] and confidential access codes and how to maintain and update company data (e.g., how to change company names and contact information).[697]

One technical specification the EDGAR Filer Manual includes is the electronic "submission type" for each submission made through the EDGAR system. The Commission expects the EDGAR electronic submission types for these documents would be designed to facilitate and expedite the submission and review of these submissions. Consistent with this proposal, the Commission preliminarily intends the EDGAR Filer Manual and the EDGARLink software would provide for two EDGAR electronic submission types: one for the submission of Form NRSRO and one for the submission of the annual reports pursuant to Rule 17g-3. The

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694 For a comprehensive discussion of Regulation S-T and electronic filing, see "Electronic Filing and the EDGAR System: A Regulatory Overview," available on the Commission's Internet website.

695 See 17 CFR 232.101.

696 As noted earlier, a CIK number is a ten-digit number uniquely identifying the person submitting the form or report.

697 In the case of name changes, the changes must be made via the EDGAR filing Internet website in advance and the new name would be reflected in the next EDGAR submission. The name on past submissions would not change.

Commission also preliminarily intends that Form NRSRO would become an electronic, fillable, form and that the Exhibits would be submitted with the Form.

As noted above, an NRSRO is not required to make the Rule 17g-3 annual reports public. Therefore, the Rule 17g-3 annual reports would be submitted through the EDGAR system on a confidential basis and would not be made available to the public to the extent permitted by law. The Commission anticipates that the EDGAR Filer Manual would provide guidance for choosing the correct submission type.

Amendments to Rule 17g-1. To implement the electronic submission through EDGAR of a Form NRSRO submitted to the Commission pursuant to paragraph (e), (f), or (g) of Rule 17g-1, the Commission proposes to amend each of those paragraphs to add a second sentence providing that a Form NRSRO and the information and documents in Exhibits 1 through 9, filed or furnished, as applicable, under the paragraph must be submitted electronically to the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.[698] Furthermore, the Commission proposes amending paragraphs (a), (b), (c), and (d) of Rule 17g-1 to provide that an NRSRO should file "two paper copies" of the Form NRSROs filed pursuant to those paragraphs. This would be designed to clarify that these filings should continue to be made in paper. In addition, in the past, some NRSROs have submitted more than two paper copies of their Form NRSRO submissions. The Commission believes that the filing of two paper copies is sufficient.

Amendments to the Instructions to Form NRSRO. To further implement the electronic submission through the EDGAR system of Form NRSROs submitted to the Commission pursuant to paragraphs (e), (f), or (g) of Rule 17g-1, the Commission proposes amending

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698 See proposed amendments to paragraphs (e), (f), and (g) of Rule 17g-1.

Instruction A.8 to Form NRSRO to distinguish between Form NRSRO submissions under paragraph (a), (b), (c), or (d) of Rule 17g-1 (which would continue to be submitted in paper form) and submissions under paragraphs (e), (f), or (g) of Rule 17g-1 (which would be submitted electronically through the EDGAR system). Currently, Instruction A.8 simply provides the address where a Form NRSRO submitted under paragraph (a), (b), (c), (d), (e), (f), or (g) of Rule 17g-1 must be submitted (i.e., the headquarters of the Commission). The Commission proposes amending Instruction 8.A to add above the address a sentence that would instruct an applicant to submit to the Commission at the address indicated below two paper copies of a Form NRSRO submitted pursuant to paragraph (a), (b), (c), or (d) of Rule 17g-1.[699] The Commission further proposes adding a sentence below the address providing that after registration, an NRSRO must submit Form NRSRO electronically to the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T, if the submission is made pursuant to paragraphs (e), (f), or (g) of Rule 17g-1.[700]

Finally, the Commission proposes amending Instruction A.9 to Form NRSRO, which currently provides that a Form NRSRO will be considered furnished to the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the Form.[701] The Commission proposes amending the instruction to read as follows: "A Form NRSRO will be considered filed with or furnished to, as applicable, the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the Form, including the instructions in Item

699 See proposed amendments to Instruction A.8 of Form NRSRO.

700 Id.

701 See Instruction A.9 to Form NRSRO.

A.8 with respect to how a Form NRSRO must be filed with or furnished to the Commission."[702] This instruction would be designed to clarify that a Form NRSRO submitted pursuant to paragraph (e), (f), or (g) of Rule 17g-1 must be submitted electronically.

Proposed Amendments to Rule 17g-3. To implement the electronic submission through the EDGAR system of the Rule 17g-3 annual reports, the Commission proposes adding two new paragraphs to Rule 17g-3: paragraphs (d) and (e).[703] Similar to the proposed amendments to paragraphs (e), (f), and (g) of Rule 17g-1, proposed new paragraph (d) of Rule 17g-3 would provide that the reports required by the rule must be submitted electronically with the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.[704] In addition, because the Rule 17g-3 annual reports are not required to be made public, the Commission proposes adding new paragraph (e) to Rule 17g-3.[705] Proposed new paragraph (e) would, in the first sentence, instruct an NRSRO that information submitted on a confidential basis and for which confidential treatment has been requested pursuant to applicable Commission rules will be accorded confidential treatment to the extent permitted by law.[706] Proposed new paragraph (e) of Rule 17g-3 would, in the second sentence, instruct an NRSRO that confidential treatment may be requested by marking each page "Confidential Treatment Requested" and by complying with Commission rules governing confidential treatment.[707]

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702 See proposed amendments to Instruction A.9 to Form NRSRO.

703 See proposed new paragraphs (d) and (e) of Rule 17g-3.

704 See proposed new paragraph (d) of Rule 17g-3.

705 See proposed new paragraph (e) of Rule 17g-3.

706 See the first sentence of proposed new paragraph (e) of Rule 17g-3.

707 See the second sentence of proposed new paragraph (e) of Rule 17g-3.

Proposed Amendments to Regulation S-T. Regulation S-T requires the electronic filing of any amendments and related correspondence and supplemental information pertaining to a document that is the subject of mandated EDGAR submission.[708] The Commission proposes amending Rule 101 of Regulation S-T[709] by adding a new paragraph (a)(1)(xiv).[710] Proposed new paragraph (a)(1)(xiv) would identify the Form NRSROs and the information and documents submitted in Exhibits 1 through 9 of Form NRSRO submitted to the Commission pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports submitted pursuant to Rule 17g-3 as submissions that must be made in electronic format.[711]

The Commission also is proposing an amendment to Rule 201 of Regulation S-T.[712] Rules 201 and 202[713] of Regulation S-T address hardship exemptions from EDGAR filing requirements, and paragraph (b) of Rule 13 of Regulation S-T[714] addresses the related issue of filing date adjustments. Under Rule 201, if an electronic filer experiences unanticipated technical difficulties that prevent the timely preparation and submission of an electronic filing, the filer may file a properly legended paper copy[715] of the filing under cover of Form TH no later than one business day after the date on which the filing was made.[716] A filer who files in paper

708 See 17 CFR 232.101(a)(1).

709 17 CFR 232.101(a)(1).

710 See proposed paragraph (a)(1)(xiv) of Rule 101 under Regulation S-T.

711 Related correspondence and supplemental information are not automatically disseminated publicly through the EDGAR system but are immediately available to the Commission staff.

712 17 CFR 232.201

713 17 CFR 232.202.

714 17 CFR 232.13(b).

715 See 17 CFR 232.201(a).

716 17 CFR 239.65, 249.447, 269.10, and 274.404.

form under the temporary hardship exemption must submit an electronic copy of the filed paper document within six business days of the filing of the paper document.[717]

In addition, an electronic filer may apply for a continuing hardship exemption under Rule 202 if it cannot file all or part of a filing without undue burden or expense.[718] The application must be made at least 10 business days before the due date of the filing. In contrast to the self-executing temporary hardship exemption process, a filer can obtain a continuing hardship exemption only by submitting a written application, upon which the Commission, or the Commission staff pursuant to delegated authority, must then act. Under paragraph (b) of Rule 13 of Regulation S-T, if an electronic filer in good faith attempts to file a document, but the filing is delayed due to technical difficulties beyond the filer's control, the filer may request that the Commission grant an adjustment of the filing date.

The Commission is proposing to make the temporary hardship exemption in Rule 201 unavailable for the submissions of Form NRSRO and the information and documents submitted in Exhibits 1 through 9 of Form NRSRO under paragraph (e), (f), or (g) of Rule 17g-1 and the annual reports required under Rule 17g-3.[719] Specifically, the Commission is proposing to amend paragraph (a) of Rule 201 of Regulation S-T to add this group of submissions to the list of submissions for which the temporary hardship exemption is unavailable.[720] An NRSRO would continue to have the ability to apply for a continuing hardship exemption under Rule 202 if it

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717 See 17 CFR 232.201(b).

718 See 17 CFR 232.202(a).

719 The Commission previously has made unavailable the ability for filers to use the temporary hardship exemption for EDGAR submissions of beneficial ownership reports filed by officers, directors and principal security holders under Section 16(a) of the Exchange Act. See Securities Act Release No. 8230 (May 7, 2003), 68 FR 25788 (May 13, 2010).

720 See proposed amendment to paragraph (a) of Rule 201 of Regulation S-T.

could not submit all or part of an application without undue burden or expense or for an adjustment of the due date under paragraph (b) of Rule 13 if there were technical difficulties beyond the NRSRO's control.

For the foregoing reasons, the Commission proposes amending Regulation S-T: (1) to provide for the mandatory electronic submission of Form NRSRO and the information and documents contained in Exhibits 1 through 9 of Form NRSRO pursuant to paragraphs (e), (f), or (g) of Rule 17g-1 and the annual reports pursuant to Rule 17g-3;[721] and (2) to amend paragraph (a) of Rule 201 to make the temporary hardship exemption unavailable for submissions of Form NRSROs and the information and documents contained in Exhibits 1 through 9 under paragraphs (e), (f), or (g) of Rule 17g-1 and the annual reports under Rule 17g-3.[722]

Request for Comment

The Commission generally requests comment on all aspects of these proposals to require the electronic submission of Form NRSRO under paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports under Rule 17g-3. The Commission also seeks comment on the following:

1. Should applicants be required to submit Form NRSRO electronically under paragraph (a), (b), (c), or (d) of Rule 17g-1?
2. What would be the impact of making the Form NRSROs required under paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports required under Rule 17g-3 mandatory electronic submissions? Are there additional burdens or costs that would result from requiring these submissions to be made electronically?
3. Are there any other difficulties and considerations unique to these proposed requirements? If so, what aspect of the proposed requirements would be burdensome?

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721 See proposed new paragraph (a)(1)(xiv) to Rule 101 of Regulation S-T.

722 See proposed amendment to paragraph (a) of Rule 201 of Regulation S-T.

Are there other alternatives that would be less burdensome? Provide specific details and alternative approaches.

4. Should NRSROs be required to submit the financial information in Form NRSRO and the information and documents contained in Exhibits 1 through 9 and the Rule 17g-3 annual reports using the XBRL format? Should NRSROs be required to use eXtensible Markup Language (XML) for EDGAR for non-financial information? Provide detailed information on any difficulties and considerations as well as benefits concerning such requirements.
5. Should the temporary hardship exemption be available for submission of these filings?

## M. OTHER AMENDMENTS

The Commission is proposing additional amendments to several of the NRSRO rules in response to amendments the Dodd-Frank Act made to sections of the Exchange Act that authorize or otherwise are relevant to these rules.

### 1. Changing "Furnish" to "File"

Section 932(a) of the Dodd-Frank Act amended Section 15E of the Exchange Act to replace the word "furnish" with the word "file" in paragraphs (b), (d), (k), and (l).[723] In addition, Section 932(a) of the Dodd-Frank Act amended paragraph (j) of Section 15E of the Exchange to, among other things, add a requirement that an NRSRO "file" a report of the designated compliance officer.[724] The Dodd-Frank Act, however, did not replace the word "furnish" with the word "file" in Section 15E(a) (which governs the submission of initial applications for registration as an NRSRO), Section 15E(e) (which governs the submission of voluntary withdrawals from registration), and Section 17(a)(1) (which provides the Commission with

[723] See Pub. L. No. 111-203 § 932(a) and 15 U.S.C. 78o-7(b), (d), (k), and (l).

[724] See Pub. L. No. 111-203 § 932(a) and 15 U.S.C. 78o-7(j)(5).

authority to, among other things, require NRSROs to furnish reports).[725] Consistent with the amendments to Section 15E described above, the Commission is proposing to amend Rule 17g-1 and Rule 17g-3 to treat certain of the submissions required in those rules as "filings" rather than "furnishings."[726] The Commission also is proposing to make corresponding amendments to Form NRSRO and the Instructions to Form NRSRO.

The Commission proposes amending paragraphs (a), (b), (c), and (d) of Rule 17g-1 to treat Form NRSROs submitted pursuant to those provisions as "filings" rather than "furnishings."[727] These paragraphs govern the submissions of initial applications for registration as an NRSRO. The Commission notes that the Dodd-Frank Act did not replace the word "furnish" with the word "file" in Section 15E(a) of the Exchange Act, which addresses the submission of initial applications for registration. The Commission, however, preliminarily believes that this was an inadvertent omission. For example, Section 15E(b)(1) refers to information "required to be filed" under Section 15E(a)(1)(B)(i) of the Exchange Act (emphasis added).[728] Similarly, Section 15E(d)(1)(B) of the Exchange Act refers to "the date on which an application for registration is filed with the Commission" (emphasis added).[729] In addition, the legislative history of Section 932(a) states that "[Title IX, Subtitle C, of the Dodd-Frank Act] requires all references to 'furnish' be replaced with the word 'file' in existing law."[730] For these

725 See 15 U.S.C. 78o-7(e) and 15 U.S.C. 78q(a)(1).

726 Among other things, an application, report, or document "filed" with the Commission pursuant to the Exchange Act or the rules thereunder is subject to the provisions of Section 18 of the Exchange Act. See 15 U.S.C. 78o-7r.

727 See proposed amendments to paragraphs (a), (b), (c), and (d) of Rule 17g-1.

728 See 15 U.S.C. 78o-7(a)(1)(B)(i).

729 See 15 U.S.C. 78o-7(d)(1)(B).

730 See Conference Report, H.R. 4173 (June 29, 2010), p. 872.

reasons, the Commission proposes to amend paragraphs (a), (b), (c), and (d) of Rule 17g-1 to treat the submissions pursuant to those paragraphs as "filings."

The Commission proposes amending paragraphs (e) and (f) of Rule 17g-1 to treat Form NRSROs submitted pursuant to those provisions as "filings" rather than "furnishings."[731] As noted above, Section 932(a) of the Dodd-Frank Act amended Section 15E(b) of the Exchange Act to replace the word "furnish" with the word "file."[732] Section 15E(b) of the Exchange Act addresses updating Form NRSRO to keep it current and the submission of the annual certification.[733] Paragraphs (e) and (f) of Rule 17g-1 govern the submission of updated Form NRSROs and annual certifications, respectively.[734] Consequently, the Commission proposes amending these paragraphs to treat the submissions of an updated Form NRSRO and an annual certification, respectively, as "filings" rather than "furnishings."[735]

The Commission is not proposing to amend paragraph (g) of Rule 17g-1 to replace the word "furnish" with the word "file." This paragraph implemented Section 15E(e) of the Exchange Act, which addresses the submission by an NRSRO of a written notice to voluntarily withdraw a registration.[736] The Commission preliminarily believes that it is not necessary to subject a notice of withdrawal of registration to the higher standards of a "filing."

Given the proposed amendments to paragraphs (a), (b), (c), (d), (e), and (f) of Rule 17g-1, the Commission proposes amending paragraphs (h) and (i) of Rule 17g-1 to reflect that a Form NRSRO would be "filed" with the Commission under the proposed amendments to paragraphs

731 See proposed amendments to paragraphs (e) and (f) of Rule 17g-1.

732 See Pub. L. No. 111-203 § 932(a)(1) and 15 U.S.C. 78o-7(b).

733 See 15 U.S.C. 78o-7(b)(1) and (2).

734 See 17 CFR 240.17g-1(e) and (f).

735 See proposed amendments to paragraphs (e) and (f) of Rule 17g-1.

736 See 15 U.S.C. 78o-7(e) and 17 CFR 240.17g-1(g).

(a), (b), (c), (d), (e), and (f) of Rule 17g-1 and "furnished" to the Commission under paragraph (g) of Rule 17g-1.

The Commission is proposing to amend paragraphs (a)(1) through (a)(5) of Rule 17g-3 to treat the reports submitted pursuant to those provisions as "filings" rather than "furnishings."[737] As noted above, Section 932(a) of the Dodd-Frank Act amended Section 15E(k) of the Exchange Act to replace the word "furnish" with the word "file."[738] Section 15E(k) of the Exchange Act provides the Commission with authority to require NRSROs to submit annual financial reports.[739] The Commission adopted paragraphs (a)(1) through (a)(5) of Rule 17g-3 under Section 15E(k).[740] Consequently, the Commission proposes amending Rule 17g-3 to treat the reports identified in paragraphs (a)(1) through (a)(5) as "filings" rather than "furnishings."[741]

In addition, the Commission proposes that the new report on internal controls discussed in Section II.A.3 of this release and the new report of the designated compliance officer discussed in Section II.K of this release be treated as "filings" rather than "furnishings."[742] Section 15E(c)(3)(B) of the Exchange Act provides, among other things, that the Commission shall prescribe rules requiring NRSROs to "submit" to the Commission an internal controls report.[743] In addition, Section 15E(j)(5)(B) of the Exchange Act, "Submission of reports to the Commission," provides that an NRSRO "shall file" the report of the designated compliance

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737 See proposed amendments to paragraphs (a)(1) through (5) of Rule 17g-3.

738 See Pub. L. No. 111-203 § 932(a)(6) and 15 U.S.C. 78o-7(k).

739 See 15 U.S.C. 78o-7(k).

740 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33590-33593 (June 18, 2007).

741 See 15 U.S.C. 78o-7(k) and proposed amendments to paragraphs (a)(1)-(5) of Rule 17g-3.

742 See proposed new paragraphs (a)(7) and (a)(8) of Rule 17g-3.

743 See 15 U.S.C. 78o-7(c)(3)(B).

officer together with the financial report that is required to be "submitted" to the Commission under Section 15E of the Exchange Act.[744] As discussed in Section II.K of this release, the financial reports are submitted pursuant to Rule 17g-3, which was adopted under Section 15E(k).[745] Moreover, as noted above, the Section 932(a)(6) of the Dodd-Frank Act amended Section 15E(k) of the Exchange Act to replace the word "furnish" with the word "file."[746] Consequently, given the interchangeable use of the word "submit" with the word "file" in Section 15E(j)(5)(B) and the legislative history discussed above, the Commission proposes to treat the new report on internal controls as a "filing."[747] As noted above, Section 15E(j)(5)(B) of the Exchange Act explicitly provides that an NRSRO "shall file" the report of the designated compliance officer.[748] Therefore, the Commission proposes to use the term "file" in proposed new paragraph (a)(8) of Rule 17g-3.[749]

The Commission does not propose to amend paragraph (a)(6) of Rule 17g-3 to treat the report identified in that paragraph as a filing. This paragraph was adopted under Section 17(a)(1) of the Exchange Act.[750] Section 17(a)(1) of the Exchange Act provides that any report an NRSRO "is required by Commission rules under this paragraph to make and disseminate to the

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744 See 15 U.S.C. 78o-7(j)(5)(B).

745 See 15 U.S.C. 78o-7(k) and 17 CFR 240.17g-3; see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33590-33593 (June 18, 2007).

746 See Pub. L. No. 111-203 § 932(a)(6) and 15 U.S.C. 78o-7(k).

747 See proposed new paragraph (a)(7) of Rule 17g-3.

748 See 15 U.S.C. 78o-7(j)(5)(B).

749 See proposed new paragraph (a)(8) of Rule 17g-3.

750 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6464-65 (Feb. 9, 2009).

Commission shall be deemed furnished to the Commission."[751] As noted above, the Dodd-Frank Act did not change this provision to make the report a "filing."

The Commission is proposing to amend Form NRSRO and the Instructions to Form NRSRO to conform the Form and its Instructions to the proposed amendments discussed above.[752] Under the proposed amendments, the Commission would replace the word "furnish" with the word "file" when referring to a Form NRSRO submitted under paragraphs (a), (b), (c), (d), (e), and (f) of Rule 17g-1. In addition, in some cases, the Commission proposes using the term "submit" when referring to a Form NRSRO that may have been submitted prior to enactment of the Dodd-Frank Act when the submission would have been "furnished to" as opposed to "filed with" the Commission. The Commission intends the word "submit" as used in this context to mean the submission was either "furnished" or "filed" depending on the applicable securities laws in effect at the time of the submission.

Request for Comment

The Commission generally requests comment on all aspects of these proposals to replace the word "furnish" with the word "file" in the Commission's NRSRO rules.

### 2. Amended Definition of NRSRO

As discussed above in Section II.I.1.c of this release, the first prong of the definition of "nationally recognized statistical rating organization" in Section 3(a)(62) of the Exchange Act, prior to being amended by the Dodd-Frank Act, provided that the entity "has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under Section 15E."[753] Section 932(b) of the Dodd-Frank Act deleted

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751 See 15 U.S.C. 78o-7q(a)(1).

752 See proposed amendments to Form NRSRO and the Instructions to Form NRSRO.

753 See Section 3(a)(62)(A) of the Exchange Act (15 U.S.C. 78c(a)(62)(A) added by the

this prong of the definition.[754] Instruction F.4 to Form NRSRO contains a definition of "NRSRO" that incorporates the Section 3(a)(62) definition as originally enacted. The Commission proposes amending this definition to conform it to the Section 3(a)(62) definition as amended by the Dodd-Frank Act.[755]

Request for Comment

The Commission generally requests comment on all aspects of this proposal to amend the definition of NRSRO in Instruction F.4 to Form NRSRO.

### 3. Definition of Asset-Backed Security

Several of the Commission's NRSRO rules impose requirements specific to credit ratings for structured finance products by providing that the rules apply to credit ratings with respect to "a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed-securities transaction."[756] This language mirrors the text of Section 15E(i) of the Exchange Act, which provides the Commission with authority to prohibit an NRSRO from the practice of "lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the [NRSRO]."[757] As noted earlier, with respect to this language, the Commission has provided the following interpretation,

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Rating Agency Act of 2006.

754 See Pub. L. No. 111-203 § 932(b).

755 See proposed amendment to Instruction F.4 to Form NRSRO.

756 See paragraphs (a)(2)(iii), (a)(7), and (b)(9) of Rule 17g-2; paragraph (a)(6) of Rule 17g-3; paragraphs (a)(3) and (b)(9) of Rule 17g-5; and paragraph (a)(4) of Rule 17g-6.

757 See 15 U.S.C. 78o-7(i).

The term "structured finance product" as used throughout this release refers broadly to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This broad category of financial instrument includes, but is not limited to, asset-backed securities such as residential mortgage-backed securities ("RMBS") and to other types of structured debt instruments such as collateralized debt obligations ("CDOs"), including synthetic and hybrid CDOs, or collateralized loan obligations ("CLOs").[758]

Section 941(a) of the Dodd-Frank Act amended Section 3 of the Exchange Act to add paragraph (a)(77), which defines the term "asset-backed security."[759] The Exchange Act definition of "asset-backed security," includes a "collateralized mortgage obligation."[760] Consequently, the Commission preliminarily believes that the current identification of structured finance products in the Commission's rules (i.e., "a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction") may have redundant terms insomuch as given the new definition of "asset-backed security" in Section 3(a)(77) of the Exchange Act an "asset-backed securities transaction" would include a "mortgage-backed securities transaction."[761] Accordingly, the Commission is proposing to delete the term "or mortgage-backed" from the identification of structured finance products in these rules.[762] The term "asset-backed security[y]" as used in the proposed new NRSRO rule definition would mean an "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act. The term "security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction" would include an asset-backed security as defined in Section

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758 Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63832, footnote 3 (Dec. 4, 2009).

759 See Pub. L. No. 111-203 § 941(a) and 15 U.S.C. 78c(a)(77).

760 See 15 U.S.C. 78c(a)(77)(A)(i).

761 See 15 U.S.C. 78c(a)(77)(A).

762 See proposed amendments to paragraphs (a)(2)(iii), (a)(7), and (b)(9) of Rule 17g-2; paragraph (a)(6) of Rule 17g-3; paragraphs (a)(3) and (b)(9) of Rule 17g-5; and paragraph (a)(4) of Rule 17g-6.

3(a)(77) of the Exchange Act and other structured finance products relating to asset-backed securities such as synthetic CDOs.

Request for Comment

The Commission generally requests comment on all aspects of these proposals to delete the term "or mortgage-backed" from the identification of structured finance products in the NRSRO rules. The Commission also seeks comment on the following:

1. Would the proposal to delete the term "or mortgage-backed" from the identification of structured finance products in the NRSRO rules change the requirements of these rules in any ways? For example, would it exclude certain types of structured finance products that currently are within the scope of these rules by narrowing the definition? Alternatively, would it add certain types of structured finance products that currently are outside the scope of these rules by broadening the definition?

**4. Other Amendments to Form NRSRO**

The Commission is proposing additional amendments to the Instructions to Form NRSRO to clarify certain requirements because the instructions, as written, have created some confusion among NRSROs.

**a. Clarification with Respect to Items 6 and 7**

The Commission is proposing amendments to Form NRSRO and the Instructions for Form NRSRO to remove potential ambiguity as to how an applicant and NRSRO must determine the approximate number of credit ratings outstanding for the purposes of Items 6 and 7. In addition, the Commission is seeking comment on how certain types of obligors, securities, and money market instruments should be classified for the purposes of Items 6 and 7.

Item 6 requires a credit rating agency applying to be registered as an NRSRO or an NRSRO applying to be registered in a new class of credit ratings to provide, among other things, the approximate number of credit ratings it has outstanding as of the date of the application in each class of credit ratings for which it is seeking registration.[763] Item 7 requires an NRSRO submitting a Form NRSRO for the purpose of updating information in the Form, making the annual certification, or withdrawing a registration to provide, among other things, the approximate number of credit ratings it had outstanding as of the end of the most recently ended calendar year in each class of credit ratings for which it is registered.[764] As noted earlier, the classes of credit ratings for which an NRSRO can be registered are: (1) financial institutions, brokers, or dealers;[765] (2) insurance companies;[766] (3) corporate issuers;[767] (4) 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);[768] and (5) issuers of government securities, municipal securities, or securities issued by a foreign government.[769]

NRSROs have raised questions about how they should count the number of credit ratings outstanding in a given class of credit ratings for the purposes of Form NRSRO.[770] For example, in some classes, certain NRSROs count the number of issuers rated but not the number of

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763 See Item 6 of Form NRSRO and Instructions B, C, D, and H (as it relates to Item 6) to Form NRSRO.

764 See Item 7 of Form NRSRO and Instructions E, F, G, and H (as it relates to Item 7) to Form NRSRO.

765 See 15 U.S.C. 78c(a)(62)(A)(i).

766 See 15 U.S.C. 78c(a)(62)(A)(ii).

767 See 15 U.S.C. 78c(a)(62)(A)(iii).

768 See 15 U.S.C. 78c(a)(62)(A)(iv).

769 See 15 U.S.C. 78c(a)(62)(A)(v).

770 See, e.g., GAO Report 10-782, pp. 46-47.

securities or money market instruments rated.[771] Other NRSROs count the number of securities or money market instruments rated (but do include the number of rated obligors in the total).[772] Finally, some NRSROs count the number of obligors, securities, and money market instruments rated.[773]

The Commission's intent in Items 6 and 7 is to elicit the total number of obligors, securities, and money market instruments in a given class of credit ratings for which the applicant or NRSRO has assigned a credit rating that was outstanding as of the applicable date (i.e., the date of the application in the case of Item 6 and the date of the most recent calendar year-end in the case of Item 7). Consequently, to make the Commission's expectations more clear, the Commission is proposing to amend the text in Items 6.A and 7.A of Form NRSRO to clarify that an applicant or NRSRO must provide the approximate number of obligors, securities, and money market instruments in each class of credit ratings for which the applicant or NRSRO has an outstanding credit rating.[774] The text in Items 6.A and 7.A currently provides that the applicant or NRSRO must provide the approximate number of credit ratings outstanding. Consequently, the amendment would clarify that the applicant or NRSRO must provide the number of "obligors, securities, and money market instruments" in the given class for which the applicant or NRSRO assigned a credit rating that was outstanding as of the applicable date.

In addition, the Commission is proposing to amend Instruction H to Form NRSRO (as it relates to Items 6.A and 7.A) in four ways. First, in conformity with the proposed amendments to the text of Items 6.A and 7.A in the Form, the Instructions would be amended to provide that

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771 Id.

772 Id.

773 Id.

774 See proposed amendments to the text in Items 6.A and 7.A respectively.

the applicant or NRSRO must, for each class of credit ratings, provide in the appropriate box the approximate number of obligors, securities, and money market instruments in that class for which the applicant or NRSRO presently has a credit rating outstanding as of the date of the application (Item 6.A) or had a credit rating outstanding as of the most recently ended calendar year (Item 7.A).

Second, Instruction H would be amended to provide that the applicant or NRSRO must treat as a separately rated security or money market instrument each individually rated security and money market instrument that, for example, is assigned a distinct CUSIP or other unique identifier, has distinct credit enhancement features as compared with other securities or money market instruments of the same issuer, or has a different maturity date as compared with other securities or money market instruments of the same issuer. This proposed instruction would be designed to clarify that each security or money market instrument of an issuer must be included in the count if it is assigned a credit rating by the applicant or NRSRO. For example, if the issuer is in the structured finance class, each tranche of the structured finance product that is assigned a credit rating must be included in the count. In addition, if an issuer issues securities or money market instruments that have different maturities, the applicant or NRSRO must include each such security in the count if the NRSRO assigns a credit rating to the security or money market instrument.

Third, Instruction H would be amended to provide that the applicant or NRSRO must not include an obligor, security, or money market instrument in more than one class of credit rating. In other words, the applicant or NRSRO cannot double count an obligor, security, or money market instrument by including it in the totals for two or more classes of credit ratings. For example, some securities have characteristics that could cause an applicant or NRSRO to classify them as municipal securities or structured finance products.[775] Nonetheless, the applicant or NRSRO would need to select the most appropriate class for the security or money market instrument and include it in the count for that class. Because some obligors, securities, and money market instruments have characteristics that could cause them to be assigned more than one class, the Commission is seeking comment below on which class would be the most appropriate for these types of obligors, securities, and money market instruments. Based on the comments received, the Commission may decide to prescribe by rule or identify through guidance how certain types of obligors, securities, and money market instruments should be classified.[776]

Fourth, Instruction H would be amended to provide that the applicant or NRSRO must include in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Exchange Act (issuers of asset-backed securities) to the extent not described in Section 3(a)(62)(B)(iv), any

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775 For example, tax exempt housing bonds share characteristics of both municipal securities and structured finance products.

776 As noted above in Sections II.E.1 and II.E.2 of this release, the comments also could inform Commission rulemaking or guidance with respect to the performance statistics that would need to be disclosed pursuant to the proposed enhancements to Exhibit 1 to Form NRSRO and the ratings history information that would need to be disclosed pursuant to new paragraph (b) of Rule 17g-7. The goal would be to have consistent disclosures in Items 6 and 7 of Form NRSRO, Exhibit 1 to Form NRSRO, and in the information about credit ratings histories that would be required under proposed new paragraph (b) of Rule 17g-7. The Commission notes other requirements in the securities laws may be triggered based on the type of obligor, security, or money market instrument being rated. See, e.g., 17 CFR 240.17g-5(a)(3) (which applies when an NRSRO issues or maintains a credit rating for a security or money market instrument issued by an asset pool or part of any asset-backed or mortgage-backed securities transaction). The Commission, in eliciting comment, is not suggesting that an obligor, security, or money market instrument having shared characteristics of, for example, a structured finance product and a municipal security, would not be subject to these other requirements because the most appropriate classification for purposes of Items 6 and 7 of Form NRSRO, Exhibit 1 to Form NRSRO, and proposed new paragraph (b) of Rule 17g-7 would be to classify it as a type of obligor, security, or money market instrument not subject to the other requirements.

rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction. As discussed above in Section II.M.3 of this release, Section 3(a)(62)(B)(iv) contains a narrower definition of "asset-backed security" than the Commission uses for the purposes of its NRSRO rules.[777] In fact, the definition is narrower than the new definition of "asset-backed security" in Section 3(a)77 of the Exchange Act.[778] The Commission expects an applicant and NRSRO to use the broader definition that captures all structured finance products when providing the number of credit ratings outstanding in this class. The proposed amendments to Instruction H to Form NRSRO would be designed to make this expectation more clear.

Request for Comment

The Commission generally requests comment on all aspects of this proposal to amend Form NRSRO Items 6.A and 7.A and Instruction H to Form NRSRO as it relates to Items 6.A and 7.A. The Commission also seeks comment on the following:

1. Would the proposed amendments to Items 6.A and 7.A and Instruction H to Form NRSRO as it relates to Items 6.A and 7.A make the Commission's expectations sufficiently clear in terms of providing the approximate number of credit ratings outstanding in each class for which an applicant is seeking registration and an NRSRO is registered? If not, how could the proposed amendments be modified to provide greater clarity?
2. How should tax-exempt housing bonds be classified for the purposes of Items 6 and 7? For example, should they be classified as: (1) issuers of asset-backed securities identified

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777 Compare 15 U.S.C. 78c(a)(62)(B)(iv), with: Instructions for Exhibit 1 to Form NRSRO; paragraphs (a)(2)(iii), (a)(7), and (b)(9) of Rule 17g-2; paragraph (a)(6) of Rule 17g-3; paragraphs (a)(3) and (b)(9) of Rule 17g-5; and paragraph (a)(4) of Rule 17g-6.

778 Compare 15 U.S.C. 78c(a)(62)(B)(iv), with 15 U.S.C. 78c(a)(77).

in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction; or (2) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 3(a)(62)(A)(v) of the Exchange Act? Is there another more appropriate classification? Commenters should provide explanations for their choices.

3. How should project finance issuances be classified for the purposes of Items 6 and 7? For example, should they be classified as: (1) corporate issuers identified in Section 3(a)(62)(A)(iii) of the Exchange Act; (2) issuers of asset-backed securities identified in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction; or (3) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 3(a)(62)(A)(v) of the Exchange Act? Is there another more appropriate classification? Commenters should provide explanations for their choices.

4. How should supra-national issuers (e.g., the World Bank) be classified for the purposes of Items 6 and 7? For example, should they be classified as: (1) financial institutions, brokers, or dealers identified in Section 3(a)(62)(A)(i) of the Exchange Act; or (2) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 3(a)(62)(A)(v) of the Exchange Act? Is there another more appropriate classification? Commenters should provide explanations for their choices.

5. How should covered bonds be classified? For example, should they be classified as: (1) financial institutions, brokers, or dealers identified in Section 3(a)(62)(A)(i) of the Exchange Act; or (2) issuers of asset-backed securities identified in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction? Is there another more appropriate classification? Commenters should provide explanations for their choices.
6. How should municipal structured finance issuers be classified? For example, should they be classified as: (1) issuers of asset-backed securities identified in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction; or (2) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 3(a)(62)(A)(v) of the Exchange Act? Is there another more appropriate classification? Commenters should provide explanations for their choices.
7. How should for-profit health care companies (e.g., hospitals, assisted living facilities, nursing homes) be treated if a municipality issues securities on behalf of the company? For example, should they be classified as: (1) corporate issuers identified in Section 3(a)(62)(A)(iii) of the Exchange Act; or (2) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 3(a)(62)(A)(v) of the Exchange Act? Is there another more appropriate classification? Commenters should provide explanations for their choices.

8. How should securitizations of health care receivables be classified? For example, should they be classified as: (1) issuers of asset-backed securities identified in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction; or (2) issuers of government securities, municipal securities, or securities issued by a foreign government identified in Section 3(a)(62)(A)(v) of the Exchange Act? Is there another more appropriate classification? Commenters should provide explanations for their choices.

9. How should insurance-linked securities be classified? For example, should they be classified as: (1) insurance companies identified in Section 3(a)(62)(A)(ii) of the Exchange Act; or (2) issuers of asset-backed securities identified in Section 3(a)(62)(A)(iv) of the Exchange Act as broadened to include any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction? Is there another more appropriate classification? Commenters should provide explanations for their choices.

10. Are there other types of obligors, securities, or money market instruments that share characteristics of one or more classes of credit ratings identified in Section 3(a)(62)(A) of the Exchange Act? If so, identify each such type of obligor, security, or money market instrument, provide a proposed classification, and explain the reason for the proposed classification.

**b. Clarification with Respect to Exhibit 8**

The Commission proposes to amend Instruction H to Form NRSRO as it relates to Exhibit 8. Exhibit 8 requires an applicant and NRSRO to provide the number of credit analysts it employs and the number of credit analyst supervisors. The Commission is proposing two amendments to the instructions for Exhibit 8. The first amendment would delete a parenthesis in the instructions that provides that the applicant or NRSRO should "see definition below" of the term "credit analyst." There is no such definition. The second amendment would clarify that the applicant or NRSRO, in providing the number of credit analysts, should include the number of credit analyst supervisors. This would be designed to ensure that the disclosures in Form NRSRO are comparable across NRSROs by avoiding the situation in which some NRSROs include credit analyst supervisors in the total number of credit analysts and some NRSROs do not include credit analyst supervisors in that amount.

Request for Comment

The Commission generally requests comment on all aspects of this proposal to amend Instruction H to Form NRSRO as it relates to Exhibit 8.

**c. Clarification with Respect to Exhibits 10 through 13**

As discussed above, paragraph (i) of Rule 17g-1 requires an NRSRO to make its current Form NRSRO and information and documents submitted in Exhibits 1 through 9 to Form NRSRO publicly available on its Internet website, or through another comparable, readily accessible means within 10 business days after the date of the Commission order granting an initial application for registration.[779] An NRSRO is not required to make Exhibits 10 through 13 of Form NRSRO publicly available or update them after registration. Instead, an NRSRO must provide similar information in the annual reports required to be filed with the Commission pursuant to Rule 17g-3.[780] An NRSRO is not required to make the annual reports public. In the

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779 See 17 CFR 240.17g-1.

780 See 17 CFR 240.17g-3; also compare Exhibits 10, 11, 12, and 13 to Form NRSRO and Instruction H of Form NRSRO (as it relates to those Exhibits), with paragraphs (a)

past, some NRSRO have submitted the annual reports required by Rule 17g-3 in the form of Exhibits 10 through 13, on a confidential basis, as part of the annual certification. Consequently, the Commission proposes to amend Instruction H in several places to add a "Note" instructing that after registration, Exhibits 10 through 13 are not required to be made publicly available by the NRSRO pursuant to Rule 17g-1(i) and they should not be updated with the filing of the annual certification. The "Note" would further instruct that similar information must be filed with the Commission not more than 90 days after the end of each fiscal year pursuant to Rule 17g-3.[781]

Request for Comment

The Commission generally requests comment on all aspects of this proposal to amend Instruction H to Form NRSRO.

## III. GENERAL REQUEST FOR COMMENT

In responding to the specific requests for comment above, the Commission encourages interested persons to provide supporting data and analysis and, when appropriate, suggest modifications to proposed rule text. Responses that are supported by data and analysis provide great assistance to the Commission in considering the practicality and effectiveness of proposed new requirements as well as weighing the benefits and costs of proposed requirements. In addition, commenters are encouraged to identify in their responses a specific request for comment by indicating the section number of the release and question number within that section to which the response is directed (e.g., Section II.E.1.a, Question #15).

The Commission also seeks comment on the proposals as a whole. In this regard, the Commission seeks comment on the following:

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through (5) of Rule 17g-3. 17 CFR 240.17g-3(a)(1)-(5).

781 See "Notes" proposed to be added to Instruction H to Form NRSRO.

1. How would the proposals integrate with provisions in other Titles and Subtitles of the Dodd-Frank Act and any regulations or proposed regulations under those other Titles and Subtitles?
2. How would the proposals integrate with existing requirements applicable to NRSROs in the Exchange Act and the regulations adopted under authority in the Exchange Act?
3. What should the implementation timeframe be for the proposed amendments and new rules? For example, should the compliance date be 60 days after publication in the Federal Register? Alternatively, should the compliance date be 90, 120, 150, 180, or some other number of days after publication? Should the proposed requirements have different time frames before their compliance dates are triggered? For example, would it take longer to come into compliance with certain of these proposals than others? If so, rank the requirements in terms of the length of time it would take to come into compliance with them and propose a schedule of compliance dates.

## IV. PAPERWORK REDUCTION ACT

Certain provisions of the proposed rule amendments and proposed new rules would contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[782] The Commission has submitted the proposed rule amendments and proposed new rules to the Office of Management and Budget ("OMB") for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number.

The titles for the collections of information are:

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[782] 44 U.S.C. 3501 et seq.; 5 CFR 1320.11.

(1) Rule 17g-1, Application for registration as a nationally recognized statistical rating organization; Form NRSRO, and Form NRSRO Instructions (OMB Control Number 3235-0625);

(2) Rule 17g-2, Records to be made and retained by nationally recognized statistical rating organizations (OMB Control Number 3235-0628);

(3) Rule 17g-3, Annual financial reports to be furnished by nationally recognized statistical rating organizations[783] (OMB Control Number 3235-0626);

(4) Rule 17g-7, Disclosure requirements (OMB Control Number 3235-0656);

(5) Rule 17g-8, Policies and procedures (a proposed new collection of information);

(6) Rule 17g-9, Standards of training, experience, and competence for credit analysts (a proposed new collection of information);

(7) Rule 17g-10, Certification of providers of third-party due diligence services in connection with asset-backed securities; Form ABS Due Diligence-15E (a proposed new collection of information);

(8) Form ABS-15G (OMB Control Number 3235-0675);

(9) Rule 15Ga-2 (a proposed new collection of information);

(10) Regulation S-T, General Rules and Regulations for Electronic Filing (OMB Control Number 3235-0424); and

(11) Form ID (OMB Control Number 3235-0328).

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783 The Commission is proposing to amend the title of Rule 17g-3 to read, "Annual financial and other reports to be filed or furnished by nationally recognized statistical rating organizations."

The proposed amendments to Rule 17g-5 (discussed in Section II.B of this release) and Rule 17g-6 (discussed in Section II.M.3 of this release) do not contain a collection of information requirement within the meaning of the PRA.

### A. SUMMARY OF COLLECTIONS OF INFORMATION UNDER THE PROPOSED RULES AND RULE AMENDMENTS

In accordance with the Dodd-Frank Act and to enhance oversight, the Commission is soliciting comment on proposed amendments to existing rules and proposed new rules that would apply to NRSROs, providers of third-party due diligence services for Exchange Act-ABS, and issuers and underwriters of Exchange Act-ABS. The following proposals contain new "collection of information" requirements within the meaning of the PRA.

#### 1. Proposed Amendments to Rule 17g-1

The Commission is proposing to amend Rule 17g-1.[784] First, to implement rulemaking mandated in Section 15E(q)(2)(D) of the Exchange Act, the Commission is proposing to amend paragraph (i) of Rule 17g-1, which requires an NRSRO to make its current Form NRSRO and information and documents submitted in Exhibits 1 through 9 publicly available on its Internet website or through another comparable, readily accessible means within 10 business days of being granted an initial registration or a registration in an additional class of credit ratings, and within 10 business days of furnishing a Form NRSRO to update information on the Form, to provide the annual certification, and to withdraw a registration.[785] The Commission's proposed amendment would require an NRSRO to make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website.[786] The proposed

784 17 CFR 240.17g-1.

785 See 15 U.S.C. 78o-7(q)(2)(D) and proposed amendments to paragraph (i) of Rule 17g-1; see also Section II.E.1.b of this release for a more detailed discussion of this proposal.

786 See proposed amendments to paragraph (i) of Rule 17g-1.

amendment to paragraph (i) also would remove the option for an NRSRO to make its Form NRSRO publicly available "through another comparable, readily accessible means" as an alternative to website disclosure.[787] In addition, the Commission is proposing amending paragraph (i) to provide that Exhibit 1 of Form NRSRO (the performance measurement statistics) be made freely available in writing when requested.[788]

Second, the Commission is proposing to amend paragraphs (e), (f), and (g) of Rule 17g-1 to require NRSROs to use the Commission's EDGAR system to electronically submit Form NRSRO and Exhibits 1 through 9 with the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.[789]

### 2. Proposed Amendments to Instructions for Exhibit 1 to Form NRSRO

The Commission is proposing to amend the instructions for Exhibit 1 to Form NRSRO.[790] The proposed amendments would be designed to implement rulemaking mandated in Section 15E(q) of the Exchange Act.[791] In particular, the amendments would confine the disclosures in the Exhibit to transition and default rates and certain limited supplemental information.[792] Moreover, the enhancements would standardize the production and presentation of the transition and default rates.[793] Specifically, the amendments would require the transition and default rates

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787 Id.

788 Id.

789 See proposed amendments to paragraphs (e), (f), and (g) of Rule 17g-1; see also Section II.L of this release for a more detailed discussion of these proposals.

790 See Instruction H to Form NRSRO (as it relates to Exhibit 1).

791 See 15 U.S.C. 78o-7(q) and proposed amendments to the instructions for Exhibit 1; see also Section II.E.1.a of this release for a more detailed discussion of this proposal.

792 See proposed amendments to the instructions for Exhibit 1.

793 Id.

in Exhibit 1 to be produced using a "single cohort approach."[794] Under this approach, an applicant and NRSRO, on an annual basis, would be required to compute how the credit ratings assigned to obligors, securities, and money market instruments in a particular class or subclass of credit rating outstanding on the date 1, 3, and 10 years prior to the most recent calendar year-end performed during respective 1, 3, and 10 year time periods.[795]

Under the amendments, the proposed new instructions would be divided into paragraphs (1), (2), (3), and (4), some of which would have subparagraphs.[796] The proposed new paragraphs would contain specific instructions with respect to, among other things, how required information should be presented in the Exhibit (including the order of presentation) and how transition and default rates should be produced using a single cohort approach.[797] As with all information that must be submitted in Form NRSRO and its Exhibits, applicants and NRSROs would be subject to these new requirements.[798]

### 3. Proposed Amendments to Rule 17g-2

The Commission proposes a number of amendments to Rule 17g-2.[799] First, the Commission proposes adding new paragraph (a)(9) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Exchange Act and paragraph (c) of Rule 17g-8 as a record that must be

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794 Id.

795 Id.

796 See proposed paragraphs (1)-(4) of the instructions for Exhibit 1.

797 Id.

798 See, e.g., 17 CFR 240.17g-1; see also Instructions A.1, B, C, D, E, and F to Form NRSRO.

799 17 CFR 240.17g-2.

made and retained.[800] Second, the Commission proposes adding new paragraph (b)(12) to Rule 17g-2 to identify the internal control structure an NRSRO must establish, maintain, enforce, and document pursuant to Section 15E(c)(3)(A) of the Exchange Act as a record that must be retained.[801] Third, the Commission proposes adding new paragraph (b)(13) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, enforce, and document pursuant to proposed paragraph (a) of new Rule 17g-8 as a record that must be retained.[802] Fourth, the Commission proposes adding new paragraph (b)(14) to Rule 17g-2 to identify the policies and procedures an NRSRO must establish, maintain, enforce, and document pursuant to proposed paragraph (b) of new Rule 17g-8 as record that must be retained.[803] Fifth, the Commission proposes adding new paragraph (b)(15) to Rule 17g-2 to identify the standards of training, experience, and competence an NRSRO must establish, maintain, enforce, and document pursuant to proposed new Rule 17g-9 as a record that must be retained.[804]

#### 4. Proposed Amendments to Rule 17g-3

The Commission proposes amending Rule 17g-3.[805] First, the Commission proposes amending paragraphs (a) and (b) of Rule 17g-3 to implement the rulemaking mandated by

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800 See proposed new paragraph (a)(9) to Rule 17g-2(a)(9); see also Section II.C.2 of this release for a more detailed discussion of this proposal.

801 See proposed new paragraph (b)(12) of Rule 17g-2; see also Section II.A.2 of this release for a more detailed discussion of this proposal.

802 See proposed new paragraph (b)(13) to Rule 17g-2; see also Section II.F.2 of this release for a more detailed discussion of this proposal.

803 See proposed new paragraph (b)(14) to Rule 17g-2; see also Section II.J.2 of this release for a more detailed discussion of this proposal.

804 See proposed new paragraph (b)(15) to Rule 17g-2; see also Section II.I.2 of this release for a more detailed discussion of this proposal.

805 17 CFR 240.17g-3.

Section 15E(c)(3)(B) of the Exchange Act.[806] The proposed amendment to paragraph (a) would add a new paragraph (a)(7) to require an NRSRO to include an additional report – the report on the NRSRO's internal control structure – with its annual submission of reports pursuant to Rule 17g-3.[807] Similar to the reports currently identified in paragraphs (a)(2) through (a)(6) of Rule 17g-3, the report identified in new paragraph (a)(7) would be unaudited.[808] The proposed amendment to paragraph (b) of Rule 17g-3 would implement Section 15E(c)(3)(B)(iii) of the Exchange Act, which provides that the annual internal controls report must contain an attestation of the NRSRO's CEO, or equivalent individual.[809] Specifically, the Commission proposes amending paragraph (b) of Rule 17g-3 to require that the NRSRO's CEO or, if the firm does not have a CEO, an individual performing similar functions, provide a signed statement that would be attached to the report.[810]

Second, the Commission is proposing that all the annual reports required to be submitted to the Commission pursuant to Rule 17g-3 be submitted through the EDGAR system.[811] To implement this requirement, the Commission proposes, among other amendments, to add new paragraph (d) to Rule 17g-3. Proposed new paragraph (d) would provide that the reports

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806 See 15 U.S.C. 78o-7(c)(3)(B) and proposed new paragraphs (a)(7) and (b)(2) of Rule 17g-3; see also Section II.A.3 of this release for a for a more detailed discussion of this proposal.

807 See proposed new paragraph (a)(7) of Rule 17g-3.

808 See 17 CFR 240.17g-3(a)(2)-(6).

809 15 U.S.C. 78o-7(c)(3)(B)(iii).

810 See proposed new paragraph (b)(2) of Rule 17g-3.

811 See proposed new paragraph (d) of Rule 17g-3; see also Section II.L of this release for a more detailed discussion of this proposal.

required by the rule must be submitted electronically with the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.[812]

Third, the Commission is proposing to add a new paragraph (a)(8) to Rule 17g-3 to identify the report of the NRSRO's designated compliance officer that an NRSRO is required to file with the Commission pursuant to Section 15E(j)(5)(B) of the Exchange Act as a report that must be filed with the other annual reports.[813] Section 15E(j)(5)(B) further provides that the NRSRO "shall file" this report with the financial report required to be submitted to the Commission under Section 15E of the Exchange Act (i.e., the Rule 17g-3 annual reports).[814] The Commission's proposal is intended to clarify how an NRSRO must adhere to the self-executing provisions in Section 15E(j)(5)(B) of the Exchange Act. Consequently, the Commission preliminary believes this requirement would not result in a collection of information requirement under the PRA because the requirement to file the report with the other annual reports required under Rule 17g-3 derives exclusively from Section 15E(j)(5)(B) of the Exchange Act (i.e., not from Commission rulemaking).[815] Moreover, the Commission is not proposing to add any additional requirements with respect to the filing other than the proposed requirement that this

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812 See proposed new paragraph (d) of Rule 17g-3.

813 See proposed new paragraph (a)(8) of Rule 17g-3; see also Section II.K of this release for a more detailed discussion of this proposal.

814 See 15 U.S.C. 78o-7(j)(5)(B). Section 15E(k) of the Exchange Act provides that each NRSRO shall, on a confidential basis, file with the Commission, at intervals determined by the Commission, such financial statements, certified (if required by the rules or regulations of the Commission) by an independent public accountant, and information concerning its financial condition, as the Commission, by rule may prescribe as necessary or appropriate in the public interest or for the protection of investors. See 15 U.S.C. 78o-7(k). The Commission implemented Section 15E(k) by adopting Rule 17g-3. See 17 CFR 240.17g-3; see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33590-33593 (June 18, 2007).

815 See 15 U.S.C. 78o-7(j)(5)(B).

report and the other annual reports be submitted through the EDGAR system, which is addressed separately in this PRA.[816]

### 5. Proposed Amendments to Rule 17g-7

The Commission proposes to amend Rule 17g-7.[817] First, the Commission is proposing to add new paragraphs (a)(1) and (2) to Rule 17g-7 to implement rulemaking mandated in Sections 15E(s)(1), (2), (3), and (4)(D) of the Exchange Act.[818] Proposed new paragraphs (a)(1) and (2) of Rule 17g-2 would require, respectively, an NRSRO when taking a rating action to publish a form containing information about the credit rating resulting from or subject to the rating action; and any certification of a provider third-party due diligence services received by the NRSRO that relates to the credit rating.[819] Proposed paragraph (a)(1) of Rule 17g-7 would contain three primary components: paragraph (a)(1)(i) prescribing the format of the form;[820] paragraph (a)(1)(ii) prescribing the content of the form;[821] and paragraph (a)(1)(iii) prescribing an attestation requirement for the form. [822] Proposed paragraph (a)(2) of Rule 17g-7 would identify a certification from a provider of third-party due diligence services as an item that must be published with a rating action.[823]

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816 Compare 15 U.S.C. 78o-7(j)(5)(B), with proposed new paragraph (a)(8) of Rule 17g-3.

817 17 CFR 240.17g-7.

818 See 15 U.S.C. 78o-7(s)(1), (2), (3), and (4)(D) and proposed new paragraph (a) of Rule 17g-7; see also Sections II.G.1 through G.5 of this release for a more detailed discussion of this proposal.

819 See proposed new paragraphs (a)(1) and (2) of Rule 17g-7.

820 See Section II.G.2 of this release for a detailed discussion of this proposal.

821 See Section II.G.3 of this release for a detailed discussion of this proposal.

822 See Section II.G.4 of this release for a detailed discussion of this proposal.

823 See Section II.G.5 of this release for a detailed discussion of this proposal.

Second, the Commission is proposing to add new paragraph (b) to Rule 17g-7. This proposed amendment would implement rulemaking mandated in Section 15E(q) of the Exchange Act by: (1) re-codifying in paragraph (b) of Rule 17g-7 requirements currently contained in paragraph (d)(3) of Rule 17g-2; and (2) substantially enhancing those requirements.[824] More specifically, paragraph (d)(3) of Rule 17g-2 requires an NRSRO to, among other things, make publicly available on its corporate Internet website in an XBRL format the information required to be documented pursuant to paragraph (a)(8) of the rule with respect to any credit rating initially determined by the NRSRO on or after June 26, 2007, the effective date of the Rating Agency Act of 2006.[825]

These requirements would be enhanced in four ways. The first enhancement would make the disclosure easier for investors and other users of credit ratings to locate. Specifically, new proposed paragraph (b)(1) of Rule 17g-7 would require the NRSRO, among other things, to publicly disclose the ratings history information for free on an easily accessible portion of its corporate Internet website.[826]

The second enhancement would broaden the scope of credit ratings subject to the disclosure requirements. Specifically, proposed new paragraph (b)(1)(i) of Rule 17g-7 would require an NRSRO to disclose each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the NRSRO is registered that was

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824 See 15 U.S.C. 78o-7(q) and proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

825 17 CFR 240.17-2(d)(3)(i)(A). Paragraph (a)(8) of Rule 17g-2 requires an NRSRO to make and retain a record that, "for each outstanding credit rating, shows all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key ("CIK") number of the rated obligor." 17 CFR 240.17-2(a)(8).

826 See proposed new paragraph (b)(1) of Rule 17g-7.

outstanding as of June 26, 2007 and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument.[827] With respect to credit ratings initially determined on our after June 26, 2007, the amendments would clarify that the disclosure of the rating history information would be triggered when an NRSRO publishes any expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating, and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument.[828]

The third enhancement would increase the scope of information that must be disclosed about a rating action. Specifically, proposed paragraph (b)(2) of Rule 17g-7 would identify 7 categories of data that would need to be disclosed when a credit rating action is published pursuant to proposed new paragraph (b)(1) of Rule 17g-7.[829] The fourth enhancement would be to require that a rating history not be removed from the disclosure until 20 years after the

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827 See proposed new paragraph (b)(1)(i) of Rule 17g-7.

828 See proposed new paragraph (b)(1)(ii) of Rule 17g-7.

829 See proposed new paragraph (b)(2) of Rule 17g-7.

NRSRO withdraws the credit rating assigned to the obligor, security, or money market instrument.[830]

### 6. Proposed New Rule 17g-8

The Commission is proposing new Rule 17g-8 that would have paragraphs (a), (b), and (c) (each paragraph would have sub-paragraphs). Proposed paragraph (a) of new Rule 17g-8 would implement rulemaking mandated in Section 15E(r) of the Exchange Act by requiring an NRSRO to have policies and procedures with respect to the procedures and methodologies the NRSRO uses to determine credit ratings.[831] In particular, proposed paragraph (a)(1) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are approved by its board of directors or, if the NRSRO does not have a board of directors, a body performing a function similar to that of a board of directors.[832] Proposed paragraph (a)(2) would require an NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are developed and modified in accordance with the policies and procedures of the NRSRO.[833] Proposed paragraph (a)(3)(i) would require an NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are applied consistently to all credit ratings to which the changed

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830 See proposed new paragraph (b)(5) of Rule 17g-7.

831 See 15 U.S.C. 78o-7(r) and proposed new paragraph (a) of Rule 17g-8; see also Section II.F.1 of this release for a more detailed discussion of this proposal.

832 See proposed paragraph (a)(1) of new Rule 17g-8.

833 See proposed paragraph (a)(2) of new Rule 17g-8.

procedures or methodologies apply.[834] Proposed paragraph (a)(3)(ii) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are, to the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to then-current credit ratings within a reasonable period of time taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated.[835] Proposed paragraph (a)(4)(i) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the NRSRO uses to determine credit ratings, the reason for the changes, and the likelihood the changes will result in changes to any current ratings.[836] Proposed paragraph (a)(4)(ii) would require the NRSRO to have policies and procedures that are reasonably designed to ensure the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website significant errors identified in a procedure or methodology, including a qualitative or quantitative model, the NRSRO uses to determine credit ratings that may result in a change in current credit ratings.[837] Finally, proposed paragraph (a)(5) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that it

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834 See proposed paragraph (a)(3)(i) of new Rule 17g-8.

835 See proposed paragraph (a)(3)(ii) of new Rule 17g-8.

836 See proposed paragraph (a)(4)(i) of new Rule 17g-8.

837 See proposed paragraph (a)(4)(ii) of new Rule 17g-8.

discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[838]

Proposed paragraph (b) of new Rule 17g-8 would implement rulemaking mandated in Section 938(a) of the Dodd-Frank Act by requiring an NRSRO to have policies and procedures with respect to the symbols, numbers, or scores it uses to denote credit ratings.[839] In particular, proposed paragraph (b)(1) of new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument.[840] Proposed paragraph (b)(2) of new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to clearly define the meaning of each symbol, number, or score in the rating scale used by the NRSRO to denote a credit rating category and notches within a category for each class and subclass of credit ratings for which the NRSRO is registered and to include such definitions in Exhibit 1 to Form NRSRO.[841] Proposed paragraph (b)(3) of new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to apply any symbol, number, or score defined pursuant to paragraph (b)(2) of new Rule 17g-8 in a manner that is consistent for all types of obligors, securities and money market instruments for which the symbol, number, or score is used.[842]

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838 See proposed paragraph (a)(5) of new Rule 17g-8.

839 See Pub. L. No. 111-203 § 938(a) and proposed paragraph (b) of new Rule 17g-8; see also Section II.J.1 of this release for a more detailed discussion of this proposal.

840 See proposed paragraph (b)(1) of new Rule 17g-8.

841 See proposed paragraph (b)(2) of new Rule 17g-8.

842 See proposed paragraph (b)(1) of new Rule 17g-8.

Proposed paragraph (c) of new Rule 17g-8 would implement rulemaking mandated in Section 15E(h)(4)(A)(ii) of the Exchange Act by requiring the NRSRO to include certain policies and procedures in the policies and procedures the NRSRO is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Exchange Act.[843] Specifically, proposed paragraph (c) would require the NRSRO to have policies and procedures to address instances in which a look-back review determines that a conflict of interest influenced a credit rating assigned to an obligor, security, or money market instrument by including, at a minimum, procedures that are reasonably designed to ensure that the NRSRO will: (1) immediately place the credit rating on credit watch and disclose certain information about the reason for the rating action; (2) promptly evaluate whether the credit rating must be revised to conform it to the NRSRO's documented procedures and methodologies for determining credit ratings (i.e., remove the influence of the conflict); and (3) promptly publish a revised credit rating, if appropriate, or affirm the credit rating, if appropriate, and, in either case, disclose certain information about the reason for the rating action.[844]

### 7. Proposed New Rule 17g-9

The Commission is proposing new Rule 17g-9.[845] This proposed rule would implement rulemaking mandated in Section 936 of the Dodd-Frank Act by requiring an NRSRO to establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings.[846] Proposed paragraph (a) of new Rule

843 See 15 U.S.C. 78o-7(h)(4)(A)(ii) and proposed new paragraph (c) of Rule 17g-8; see also Section II.C.1 of this release for a more detailed discussion of this proposal.

844 See proposed paragraphs (c)(1), (2) and (3) of new Rule 17g-8.

845 Proposed new Rule 17g-9 would be codified at 17 CFR 240.17g-9, if adopted.

846 See Pub. L. No. 111-203 § 936 and proposed new Rule 17g-9; see also Section II.I.1 of this release for a more detailed discussion of this proposal.

17g-9 would require an NRSRO to establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings that are reasonably designed to achieve the objective that such individuals produce accurate credit ratings in the classes and subclasses of credit ratings for which the NRSRO is registered.[847] Proposed paragraph (b) would identify four factors the NRSRO must consider when designing the standards.[848] Proposed paragraph (c) would prescribe two requirements an NRSRO must incorporate into its standards of training, experience, and competence.[849]

### 8. Proposed New Rule 17g-10 and Form ABS Due Diligence-15E

The Commission is proposing new Rule 17g-10 and new Form ABS Due Diligence-15E.[850] The new rule and form would implement rulemaking mandated in Sections 15E(s)(4)(B) and (C) of the Exchange Act.[851] Proposed new Rule 17g-10 would contain three paragraphs: (a), (b) and (c).[852] Proposed paragraph (a) would provide that the written certifications of providers of third-party due diligence services required pursuant to Section 15E(s)(4)(B) of the Exchange Act must be made on Form ABS Due Diligence-15E.[853] Proposed paragraph (b) of new Rule

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847 See proposed paragraph (a) of new Rule 17g-9; see also Section II.I.1.a of this release for a more detailed discussion of this proposal.

848 See proposed paragraphs (b)(1)-(4) of new Rule 17g-9; see also Section II.I.1.b of this release for a more detailed discussion of this proposal.

849 See proposed paragraphs (c)(1) and (2) of new Rule 17g-9; see also Section II.I.1.c of this release for a more detailed discussion of this proposal.

850 Proposed new Rule 17g-10 would be codified at 17 CFR 240.17g-10 and proposed new Form ABS Due Diligence-15E would be identified at 17 CFR 249b.400.

851 See 15 U.S.C. 78o-7(s)(4)(B) and (C), proposed new Rule 17g-10, and proposed new Form ABS Due Diligence-15E; see also Section II.H of this release for a more detailed discussion of this proposal.

852 See proposed paragraphs (a), (b) and (c) of Rule 17g-10 see also Section II.H.2 of this release for a more detailed discussion of this proposal.

853 See proposed paragraph (a) of new Rule 17g-10.

17g-10 would provide that the written certification must be signed by an individual who is duly authorized by the person providing the third-party due diligence services to make such a certification.[854] Proposed paragraph (c) of new Rule 17g-10 would contain four definitions to be used for the purposes of Section 15E(s)(4)(B) and Rule 17g-10; namely, a definition of "due diligence services,"[855] "issuer,"[856] "originator,"[857] and "securitizer."[858]

Proposed Form ABS Due Diligence-15E would contain five line items identifying information the provider of third-party due diligence services would need to provide in the form.[859] It also would contain a signature line with a corresponding representation.[860] Item 1 would elicit the identity and address of the provider of third-party due diligence services.[861] Item 2 would elicit the identity and address of the issuer, underwriter, or NRSRO that employed the provider of third-party due diligence services.[862] Item 3 would instruct the provider of third-party due diligence services to identify each NRSRO whose published criteria for performing due diligence the provider of third-party due diligence services satisfied in performing the due diligence review.[863] Item 4 would require the provider of third-party due diligence services to

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854 See proposed paragraph (b) of Rule 17g-10.

855 See proposed paragraph (c)(1) of new Rule 17g-10.

856 See proposed paragraph (c)(2) of new Rule 17g-10.

857 See proposed paragraph (c)(3) of new Rule 17g-10.

858 See proposed paragraph (c)(4) of new Rule 17g-10.

859 See proposed new Form ABS Due Diligence-15E; see also Section II.H.3 of this release for a more detailed discussion of this proposal.

860 See proposed new Form ABS Due Diligence-15E.

861 See Item 1 to proposed Form ABS Due Diligence-15E.

862 See Item 2 to proposed Form ABS Due Diligence-15E.

863 See Item 3 to proposed Form ABS Due Diligence 15E.

describe the scope and manner of the due diligence performed.[864] Item 5 would require the provider of third-party due diligence services to describe the findings and conclusions resulting from the review.[865]

### 9. Rule 15Ga-2 and Form ABS-15G

The Commission is proposing new Rule 15Ga-2 and amendments to Form ABS-15G.[866] The new rule and amended form would implement Section 15E(s)(4)(A) of the Exchange Act.[867] Proposed new Rule 15Ga-2 would require an issuer or underwriter of any Exchange Act-ABS that is to be rated by an NRSRO to furnish a Form ABS-15G on the EDGAR system containing the findings and conclusions of any third-party "due diligence report" obtained by the issuer or underwriter. The rule would define "due diligence report" as any report containing findings and conclusions relating to "due diligence services" as defined in proposed new Rule 17g-10.[868] Under the proposal, the disclosure would be furnished using Form ABS-15G for both registered and unregistered offerings of Exchange Act-ABS. In addition, under the Commission's proposal, an issuer or underwriter would not need to furnish Form ABS-15G if the issuer or underwriter obtains a representation from each NRSRO engaged to produce a credit rating for the Exchange Act-ABS that can be reasonably relied on that the NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the

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864 See Item 4 to proposed Form ABS Due Diligence 15E.

865 See Item 5 to proposed Form ABS Due Diligence 15E.

866 See proposed new Rule 15Ga-2 and proposed amendments to Form ABS-15G.

867 See 15 U.S.C. 78o-7(s)(4)(A), proposed new Rule 15Ga-2, and proposed amendments to Form ABS-15G; see also Section II.H.1 of this release for a more detailed discussion of this proposal.

868 See proposed paragraph (c)(1) of new Rule 17g-10.

offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7.[869]

### 10. Proposed Amendments to Regulation S-T

The Commission is proposing that certain Form NRSRO submissions and all Rule 17g-3 annual report submissions be submitted to the Commission using the EDGAR system.[870] In order to implement this requirement, the Commission is proposing amendments to Rule 101 of Regulation S-T to require Form NRSROs and Exhibits 1 through 9 submitted pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports submitted pursuant Rule 17g-3 be submitted through the EDGAR system.[871] The Commission also is proposing to amend Rule 201 of Regulation S-T, which governs temporary hardship exemptions from electronic filing, to make this exemption unavailable for NRSRO filings.[872]

The Commission also is proposing amendments to Rule 314 of Regulation S-T to permit municipal securitizers of Exchange Act-ABS, or underwriters in the offering of municipal Exchange Act-ABS, to provide the information required by Form ABS-15G on EMMA, the Municipal Securities Rulemaking Board's centralized public database.[873]

### 11. Form ID

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869 See proposed new paragraph (a)(1) of Rule 17g-7.

870 See proposed amendment of Rule 101 of Regulation S-T (17 CFR 231.101); see also Section II.L of this release for a more detailed discussion of this proposal.

871 See proposed new paragraph (a)(xiv) of Rule 101 of Regulation S-T.

872 See proposed amendment to paragraph (a) of Rule 201 of Regulation S-T (17 CFR 231.201); see also Section II.L of this release for a more detailed discussion of this proposal.

873 See proposed amendments to Rule 314 of Regulation S-T (17 CFR 231.314); see also Section II.H.1 of this release for a more detailed discussion of this proposal.

NRSROs would need to file a Form ID with the Commission in order to gain access to the Commission's EDGAR system to make electronic filings with the Commission.[874]

The Commission preliminarily believes that the issuers and underwriters of Exchange Act-ABS that would need to furnish Form ABS-15G to the Commission through the EDGAR system pursuant to proposed new Rule 15Ga-2 already have access to the EDGAR system because, for example, they need such access for the purpose of Rule 15Ga-1.

## B. PROPOSED USE OF INFORMATION

### 1. Proposed Amendments to Rule 17g-1

The Commission proposes amending paragraph (i) of Rule 17g-1 to require that an NRSRO make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website.[875] The proposed amendment to paragraph (i) also would remove the option for an NRSRO to make its Form NRSRO publicly available "through another comparable, readily accessible means" as an alternative to Internet disclosure. In addition, the Commission is proposing amending paragraph (i) to provide that Exhibit 1 of Form NRSRO (the performance measurement statistics) be made freely available in writing when requested. Second, the Commission is proposing to amend paragraphs (e), (f), and (g) of Rule 17g-1 to require that NRSROs use the Commission's EDGAR system to electronically file or submit Form NRSRO with the Commission pursuant to these paragraphs in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.[876]

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874 See Section II.L of this release for a more detailed discussion of these proposals.

875 See proposed amendments to paragraph (i) of Rule 17g-1; see also Section II.E.1.b of this release for a more detailed discussion of this proposal.

876 See proposed amendments to paragraphs (e), (f), and (g) of Rule 17g-1; see also Section II.L of this release for a more detailed discussion of these proposals.

The proposed requirements that an NRSRO make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website and file the Form through the EDGAR system are designed to make this information more readily accessible to investors and other users of credit ratings. As the Commission stated when adopting Form NRSRO, the Form will provide users of credit ratings with information that will assist them in comparing NRSROs and understanding how a given NRSRO conducts its business activities.[877] In addition, the filing of the Form NRSROs on the EDGAR system would allow Commission examiners to more easily retrieve the submissions of a specific NRSRO to prepare for an examination. Furthermore, having the Forms filed and stored through the EDGAR system (i.e., in a centralized location), would assist the Commission from a records management perspective by establishing a more automated storage process and creating efficiencies in terms of reducing the volume of paper filings that must be manually processed and stored.

### 2. Proposed Amendments to Instructions for Exhibit 1 to Form NRSRO

The Commission is proposing to amend the instructions for Exhibit 1 to Form NRSRO.[878] The amendments would confine the disclosures in the Exhibit to transition and default rates and certain limited supplemental information.[879] Moreover, the amendments would standardize the production and presentation of the transition and default rates. As the Commission stated when adopting Form NRSRO, the information provided in Exhibit 1 is an important indicator of the performance of an NRSRO in terms of its ability to assess the creditworthiness of issuers and

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877 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR 33569-335670 (June 18, 2007).

878 See Instruction H to Form NRSRO (as it relates to Exhibit 1).

879 See proposed amendments to the instructions for Exhibit 1 to Form NRSRO (17 CFR 249b.300); see also Section II. E.1.a of this release for a more detailed discussion of this proposal.

obligors and, consequently, will be useful to users of credit ratings in evaluating an NRSRO.[880] In addition, Commission staff would use the enhanced performance statistics provided in an applicant's initial application for registration and in an NRSRO's Form NRSRO to, among other things, assess whether the applicant or NRSRO has adequate financial and managerial resources to consistently produce credit ratings with integrity.[881] For example, statistics indicating the applicant or NRSRO is performing poorly in determining credit ratings could be an indication the applicant or NRSRO fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity in a particular class or subclass of credit ratings. Finally, the disclosure of the enhanced performance statistics in an applicant's initial application would allow the Commission staff to verify that the applicant, if granted registration, would publicly disclose the information in accordance with the proposed amendments to the Instructions for Exhibit 1.[882]

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880 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33574 (June 18, 2007); see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6474 (Feb. 9, 2009) ("The amendments to the instructions to Exhibit 1 to Form NRSRO will require NRSROs to provide more detailed performance statistics and, thereby, make it easier for users of credit ratings to compare the performance of the NRSROs.").

881 See, e.g., 15 U.S.C. 78o-7(a)(2)(C) (setting forth grounds to deny an initial application) and 15 U.S.C. 78o-7(d)(1)(E) and (d)(2) (setting forth grounds to sanction an NRSRO, including revoking the NRSRO's registration); see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33612 (June 18, 2007) ("Form NRSRO requires that a credit rating agency provide information required under Section 15E(a)(1)(B) of the Exchange Act and certain additional information. The additional information will assist the Commission in making the assessment regarding financial and managerial resources required under Section 15E(a)(2)(C)(2)(ii)(I) of the Exchange Act.").

882 As indicated above, paragraph (i) requires an NRSRO to make Form NRSRO and Exhibits 1 through 9 publicly available within 10 business days of being granted an initial registration. See 17 CFR 240.17g-1(i). In addition, the public disclosure of Form NRSRO and Exhibits 1 through 9 could be accelerated if the Commission adopts the proposal that this information be filed through the EDGAR system upon registration.

### 3. Proposed Amendments to Rule 17g-2

The Commission proposes adding paragraph (a)(9) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Exchange Act and proposed paragraph (c) of new Rule 17g-8 as a record that must be made and retained.[883] In addition, the Commission is proposing to add the following new paragraphs to Rule 17g-2 to identify additional records that must be retained: (1) paragraph (b)(12) would identify the internal control structure an NRSRO must establish, maintain, enforce, and document pursuant to Section 15E(c)(3)(A);[884] (2) paragraph (b)(13) would identify the policies and procedures an NRSRO is required to establish, maintain, enforce, and document pursuant to proposed paragraph (a) of new Rule 17g-8;[885] (3) paragraph (b)(14) would identify the policies and procedures an NRSRO must establish, maintain, enforce, and document pursuant to proposed paragraph (b) of new Rule 17g-8;[886] and (4) paragraph (b)(15) would identify the standards of training, experience, and competence an NRSRO must establish, maintain, enforce, and document pursuant to proposed new Rule 17g-9.[887]

The proposed requirement that a record of the policies and procedures identified in proposed new paragraph (a)(9) of Rule 17g-2 be made (i.e., documented) would promote better understanding of them among the individuals within the organization and, therefore, promote

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883 See proposed new paragraph (a)(9) to Rule 17g-2(a)(9); see also Section II.C.2 of this release for a more detailed discussion of this proposal.

884 See proposed new paragraph (b)(12) of Rule 17g-2; see also Section II.A.2 of this release for a more detailed discussion of this proposal.

885 See proposed new paragraph (b)(13) to Rule 17g-2; see also Section II.F.2 of this release for a more detailed discussion of this proposal.

886 See proposed new paragraph (b)(14) to Rule 17g-2; see also Section II.J.2 of this release for a more detailed discussion of this proposal.

887 See proposed new paragraph (b)(15) to Rule 17g-2; see also Section II.I.2 of this release for a more detailed discussion of this proposal.

compliance with such policies and procedures. The requirement that the policies and procedures identified in proposed new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) be retained would subject these records to the various retention and production requirements of paragraphs (c), (d), (e), and (f) of Rule 17g-2.[888] The Commission staff would use these records to review whether an NRSRO was complying with the provisions of the securities laws requiring the NRSRO to establish, maintain, enforce, and document these policies, procedures, and standards.[889]

### 4. Proposed Amendments to Rule 17g-3

The Commission proposes amending paragraphs (a) and (b) of Rule 17g-3 to implement the rulemaking mandated by Section 15E(c)(3)(B) of the Exchange Act.[890] The proposed

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888 See 17 CFR 240.17g-2(c), (d), (e) and (f). Paragraph (c) of Rule 17g-2 requires an NRSRO to retain the records identified in paragraphs (a) and (b) for three years after the date the record is made or received. 17 CFR 240.17g-2(c). Paragraph (d) requires, among other things, that an NRSRO maintain each record required to be retained pursuant to paragraphs (a) and (b) in a manner that makes the original record or copy easily accessible to the principal office of the NRSRO. 17 CFR 240.17g-2(d). Paragraph (e) sets forth the requirements that apply when an NRSRO uses a third-party custodian to maintain its records. 17 CFR 240.17g-2(e). Paragraph (f) requires an NRSRO to promptly furnish the Commission with legible, complete, and current copies, and, if specifically requested, English translations, of those records of the NRSRO required to be retained pursuant to paragraphs (a) and (b), or any other records of the NRSRO subject to examination under Section 17(b) of the Exchange Act. See 17 CFR 240.17g-2(f); see also 15 U.S.C. 78q(b).

889 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33582 (June 18, 2007) ("The Commission designed [Rule 17g-2] based on its experience with recordkeeping rules for other regulated entities. These other books and records rules have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws. Rule 17g–2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is complying with the provisions of Section 15E of the Exchange Act and the rules thereunder.") (footnotes omitted).

890 See proposed new paragraphs (a)(7) and (b)(2) of Rule 17g-3; see also Section II.A.3 of this release for a for a more detailed discussion of this proposal.

amendment to paragraph (a) would add a new paragraph (a)(7) to require an NRSRO to include an additional report – a report on the NRSRO's internal control structure – with its annual submission of reports pursuant to Rule 17g-3. The proposed amendment to paragraph (b) of Rule 17g-3 would require that the NRSRO's CEO or, if the firm does not have a CEO, an individual performing similar functions, provide a signed statement that would be attached to the report. The Commission staff would use this report along with the other Rule 17g-3 annual reports to monitor the NRSRO's compliance with applicable securities laws.[891] For example, Section 15E(c)(3)(A) of the Exchange Act requires an NRSRO to "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings."[892] Among other things, the annual report that an NRSRO would file pursuant to proposed new paragraph (a)(7) of Rule 17g-3 would require the NRSRO to provide an assessment by management of the effectiveness of the internal control structure. Consequently, Commission staff could use the report as a starting point to assess whether the NRSRO is complying with Section 15E(c)(3)(A) of the Exchange Act.[893]

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891 See, e.g., Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33612-33613 (June 18, 2007) ("[Rule 17g-3] will aid the Commission in monitoring whether the initiation of a proceeding under Section 15E(d) of the Exchange Act will be appropriate because the NRSRO 'fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity. In addition, the financial reports also will assist the Commission in monitoring potential conflicts of interest of a financial nature arising from the operation of an NRSRO.'") (footnotes omitted); see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6465 (Feb. 9, 2009) ("[The amendment to Rule 17g-3] will assist the Commission in its examination function of NRSROs.").

892 15 U.S.C. 78o-7(c)(3)(A).

893 Id.

The Commission also is proposing that all the annual reports required to be submitted to the Commission pursuant to Rule 17g-3 be submitted through the EDGAR system.[894] The submission of the annual reports through the EDGAR system would allow Commission examiners to more easily retrieve the reports of a specific NRSRO to prepare for an examination. Moreover, having these reports submitted and stored through the EDGAR system (i.e., in a centralized location), would assist the Commission from a records management perspective by establishing a more automated storage process and creating efficiencies in terms of reducing the volume of paper submissions that must be manually processed and stored.

### 5. Proposed Amendments to Rule 17g-7

The Commission proposes to amend Rule 17g-7.[895] First, the Commission is proposing to add new paragraphs (a)(1) and (2) to Rule 17g-7 to implement rulemaking mandated in Sections 15E(s)(1), (2), (3), and (4)(D) of the Exchange Act.[896] Proposed new paragraphs (a)(1) and (2) of Rule 17g-2 would require, respectively, an NRSRO when taking a rating action to publish a form containing information about the credit rating resulting from or subject to the rating action; and any certification of a provider of third-party due diligence services received by the NRSRO that relates to the credit rating.[897] As stated in Section 15E(s)(1)(B) of the Exchange Act, the purpose of the disclosures required in the form would be to provide information that can be used by investors and other users of credit ratings to better understand credit ratings in each

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894 See proposed new paragraph (d) of Rule 17g-3; see also Section II.L of this release for a more detailed discussion of this proposal.

895 17 CFR 240.17g-7.

896 See 15 U.S.C. 78o-7(s)(1), (2), (3), and (4)(D) and proposed new paragraph (a) of Rule 17g-7; see also Sections II.G.1 through G.5 of this release for a more detailed discussion of this proposal.

897 See proposed new paragraphs (a)(1) and (2) of Rule 17g-7.

class of credit rating issued by the NRSRO.[898] Furthermore, as stated in Section 15E(s)(4)(D) of the Exchange Act, the purpose of the disclosure of the certification would be to allow the public to determine the adequacy and level of due diligence services provided by a third-party.[899]

Second, the Commission is proposing to add new paragraph (b) to Rule 17g-7.[900] The proposed amendments would: (1) re-codify in paragraph (b) of Rule 17g-7 requirements currently contained in paragraph (d)(3) of Rule 17g-2; and (2) substantially enhance those requirements. Under the current and proposed enhanced requirements, an NRSRO is (and would be) required to disclose certain historical information about its credit ratings. As the Commission stated when adopting the current disclosure requirement, the "intent of the rule is to facilitate comparisons of credit rating accuracy across all NRSROs–including direct comparisons of different NRSROs' treatment of the same obligor or instrument—in order to enhance NRSRO accountability, transparency, and competition."[901] The proposals also are designed to provide persons with the "raw data" necessary to generate statistical information about the performance

898 See 15 U.S.C. 78o-7(s)(1)(B).

899 See 15 U.S.C. 78o-7(s)(4)(D).

900 See proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

901 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63838 (Dec. 4, 2009) ("Ratings history information for outstanding credit ratings is the most direct means of comparing the performance of two or more NRSROs. It allows an investor or other user of credit ratings to compare how all NRSROs that maintain a credit rating for a particular obligor or instrument initially rated that obligor or instrument and, thereafter, how and when they adjusted their credit rating over time."). The Commission notes that under the proposals the disclosures would not contain complete histories for many credit ratings because the NRSRO would not need to include information about rating actions taken before June 26, 2007. However, the Commission believes that the disclosures would still be used to compare how different NRSROs rated a particular obligor, security, or money market instrument beginning as of June 26, 2007 and from that date forward.

of each NRSRO's credit ratings.[902] Finally, the proposals are designed to implement provisions of Section 15E(q)(2) of the Exchange Act, which provides, among other things, that the Commission's rules shall require NRSROs to disclose information about the performance of credit ratings that is comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs.[903]

### 6. Proposed New Rule 17g-8

The Commission is proposing new Rule 17g-8 that would have paragraphs (a), (b), and (c) (each paragraph would have sub-paragraphs). Paragraph (a) of new Rule 17g-8 would implement Section 15E(r) of the Exchange Act by requiring an NRSRO to have policies and procedures with respect to the procedures and methodologies the NRSRO uses to determine credit ratings.[904] These policies and procedures would be used by the NRSRO to achieve the objectives identified in Section 15E(r) of the Exchange Act,[905] namely, that the NRSRO:

- determines credit ratings using procedures and methodologies, including qualitative and quantitative data and models, that are approved by the board of the NRSRO, or a body performing a function similar to that of a board;[906]

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902 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63837-63838 (Dec. 4, 2009) ("The raw data to be provided by NRSROs pursuant to the new ratings history disclosure requirements...will enable market participants to develop performance measurement statistics that would supplement those required to be published by NRSROs themselves in Exhibit 1, tapping into the expertise of credit market observers and participants in order to create better and more useful means to compare the credit ratings performance of NRSROs.").

903 See 15 U.S.C. 78o-7(q)(2).

904 See 15 U.S.C. 78o-7(r) and proposed new paragraph (a) of Rule 17g-8; see also Section II.F.1 of this release for a more detailed discussion of this proposal.

905 See 15 U.S.C. 78o-7(r)(1)-(3).

906 See 15 U.S.C. 78o-7(r)(1)(A).

- determines credit ratings using procedures and methodologies, including qualitative and quantitative data and models, that are in accordance with the policies and procedures of the NRSRO for the development and modification of credit rating procedures and methodologies;[907]
- when material changes are made to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models), applies the changes consistently to all credit ratings to which the changed procedures and methodologies apply;[908]
- when material changes are made to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models), to the extent that changes are made to credit rating surveillance procedures and methodologies, applies the changes to then-current credit ratings within a reasonable time period determined by the Commission, by rule;[909]
- when material changes are made to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models), the NRSRO publicly discloses the reason for the change;[910]
- notifies users of credit ratings of the version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[911]

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907 See 15 U.S.C. 78o-7(r)(1)(B).

908 See 15 U.S.C. 78o-7(r)(2)(A).

909 15 U.S.C. 78o-7(r)(2)(B).

910 See 15 U.S.C. 78o-7(r)(2)(C).

911 15 U.S.C. 78o-7(r)(3)(A).

- notifies users of credit ratings when a material change is made to a procedure or methodology, including to a qualitative model or quantitative input;[912]
- notifies users of credit ratings when a significant error is identified in a procedure or methodology, including a qualitative or quantitative model, that may result in credit rating actions;[913] and
- notifies users of credit ratings when a material change is made to a procedure or methodology, including to a qualitative model or quantitative input, of the likelihood the change will result in a change in current credit ratings.[914]

Proposed paragraph (b) of new Rule 17g-8 would implement Section 938(a) of the Dodd-Frank Act by requiring an NRSRO to have policies and procedures with respect to the symbols, numbers, or scores it uses to denote credit ratings.[915] These policies and procedures would be used by the NRSRO to achieve the objectives mandated in Sections 938(a)(1) through (3) of the Dodd-Frank Act.[916] Namely, that the NRSRO establishes, maintains, and enforces written policies and procedures to: (1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;[917] (2) clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating;[918]

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912 See 15 U.S.C. 78o-7(r)(3)(B).

913 See 15 U.S. C. 78o-7(r)(3)(C).

914 See 15 U.S.C. 78o-7(r)(3)(D).

915 See Pub. L. No. 111-203 § 938(a) and proposed paragraph (b) of new Rule 17g-8; see also Section II.J.1 of this release for a more detailed discussion of this proposal.

916 See Pub. L. No. 111-203 §§ 938(a)(1)-(3).

917 See Pub. L. No. 111-203 § 938(a)(1).

918 See Pub. L. No. 111-203 § 938(a)(2).

and (3) apply any symbol described in item (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.[919]

Proposed paragraph (c) of new Rule 17g-8 would implement Section 15E(h)(4)(A)(ii) of the Exchange Act by requiring the NRSRO to include certain policies and procedures in the policies and procedures the NRSRO is required to establish, maintain, and enforce under Section 15E(h)(4)(A) of the Exchange Act.[920] These policies and procedures would be used by the NRSRO: (1) to achieve the objective specified in Section 15E(h)(4)(A)(ii) of the Exchange Act to revise a credit rating, if appropriate, when a look-back review determines the credit rating was influenced by the conflict of interest of the credit analyst seeking employment with the person subject to the credit rating or the issuer, underwriter, or sponsor of a security or money market instrument subject to the credit rating;[921] and (2) to make the disclosures that would be required in proposed new paragraph (a)(1)(ii)(J)(3) of Rule 17g-7.[922]

### 7. **Proposed New Rule 17g-9**

The Commission is proposing new Rule 17g-9.[923] This rule would implement Section 936 of the Dodd-Frank Act by requiring an NRSRO to establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings.[924] These standards would be used by the NRSRO to achieve the objectives specified in Sections 936(1) and (2) of the Dodd-Frank Act that any person employed

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919 See Pub. L. No. 111-203 § 938(a)(3).

920 See 15 U.S.C. 78o-7(h)(4)(A)(ii) and proposed new paragraph (c) of Rule 17g-8; see also Section II.C.1 of this release for a more detailed discussion of this proposal.

921 See 15 U.S.C. 78o-7(h)(4)(A)(ii).

922 See proposed paragraph (a)(1)(ii)(J)(3) of Rule 17g-7.

923 Proposed new Rule 17g-9 would be codified at 17 CFR 240.17g-9, if adopted.

924 See Pub. L. No. 111-203 § 936 and proposed new Rule 17g-9; see also Section II.I.1 of this release for a more detailed discussion of this proposal.

by the NRSRO to perform credit ratings produces accurate ratings for the categories of issuers whose securities the person rates and is tested for knowledge of the credit rating process.[925]

### 8. Proposed New Rule 17g-10 and Form ABS Due Diligence-15E

The Commission is proposing new Rule 17g-10 and new Form ABS Due Diligence-15E.[926] Proposed new Rule 17g-10 would implement rulemaking mandated in Sections 15E(s)(4)(B) and (C) of the Exchange Act by requiring that the written certification a provider of third-party due diligence services must provide to an NRSRO be made on Form ABS Due Diligence-15E.[927] Proposed new Rule 17g-10 and proposed new Form ABS Due Diligence-15E would be designed to achieve the objective stated in Section 15E(s)(4)(B) of the Exchange Act; namely, that the provider of third-party due diligence services conducts a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate credit rating.[928] They also would be designed – in combination with the disclosure requirement in proposed new paragraph (a)(2) of Rule 17g-7 – to achieve the objective stated in Section 15E(s)(4)(D) of the Exchange Act; namely, to allow the public to determine the adequacy and level of due diligence services provided by a third party.[929]

### 9. Rule 15Ga-2 and Form ABS-15G

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925 Pub. L. No. 111-203 §§ 936(1) and (2).

926 Proposed new Rule 17g-10 would be codified at 17 CFR 240.17g-10 and proposed new Form ABS Due Diligence-15E would be identified at 17 CFR 249b.400.

927 See 15 U.S.C. 78o-7(s)(4)(B) and (C), proposed new Rule 17g-10, and proposed new Form ABS Due Diligence-15E; see also Sections II.H of this release for a more detailed discussion of this proposal.

928 See 15 U.S.C. 78o-7(s)(4)(B).

929 See 15 U.S.C. 78o-7(s)(4)(D); see also Sections II.G.5 of this release for a more detailed discussion of proposed new paragraph (a)(2) of Rule 17g-7.

The Commission is proposing new Rule 15Ga-2 and amendments to Form ABS-15G.[930] The new rule and amended form would implement Section 15E(s)(4)(A) of the Exchange Act.[931] Proposed new Rule 15Ga-2 would require an issuer or underwriter of any Exchange Act-ABS that is to be rated by an NRSRO to furnish a Form ABS-15G on the EDGAR system containing the findings and conclusions of any third-party "due diligence report" obtained by the issuer or underwriter. Under the proposal, the disclosure would be furnished using Form ABS-15G for both registered and unregistered offerings of Exchange Act-ABS. In addition, under the Commission's proposal, an issuer or underwriter would not need to furnish Form ABS-15G if the issuer or underwriter obtains a representation from each NRSRO engaged to produce a credit rating for the Exchange Act-ABS that can be reasonably relied on that the NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7.

The information proposed to be disclosed under these requirements would be used by investors and other users of credit ratings to determine the adequacy and level of due diligence services provided by a third party. In addition, if no disclosure is made, investors and other users of credit ratings would be put on notice that the issuer or underwriter did not employ a provider of third-party due diligence services in connection with the offering of an Exchange Act-ABS.

#### 10. Proposed Amendments to Regulation S-T

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930 See proposed new Rule 15Ga-2 and proposed amendments to Form ABS-15G.

931 See 15 U.S.C. 78o-7(s)(4)(A); see also Section II.H.1 of this release for a more detailed discussion of this proposal.

As noted above, the Commission is proposing that certain Form NRSRO submissions and all Rule 17g-3 annual report submissions be made through the EDGAR system. In order to implement this requirement, the Commission is proposing amendments to Rule 101 of Regulation S-T to require that the EDGAR system be used to submit Form NRSRO pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports pursuant Rule 17g-3.[932] The Commission also is proposing to amend Rule 201 of Regulation S-T, which governs temporary hardship exemptions from electronic filings, to make this exemption unavailable for NRSRO submissions.[933]

These proposed requirements would implement the proposals that NRSROs use the EDGAR system to submit Form NRSROs pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports pursuant to Rule 17g-3. With respect to the Form NRSROs, the proposal is designed to make the information contained in the Form more readily accessible to investors and other users of credit ratings. As the Commission stated when adopting Form NRSRO, the Form will provide users of credit ratings with information that will assist them in comparing NRSROs and understanding how a given NRSRO conducts its business activities.[934] In addition, the filing of the Form NRSROs and annual reports on the EDGAR system would allow Commission examiners to more easily retrieve the Forms of a specific NRSRO to prepare for an examination. Moreover, having the Forms and annual reports filed and stored through the EDGAR system (i.e., in a centralized location), would assist the Commission from a records

932 See proposed amendment of Rule 101 of Regulation S-T (17 CFR 231.101); see also Section II.L of this release for a more detailed discussion of this proposal.

933 See proposed amendment of Rule 201 of Regulation S-T (17 CFR 231.201); see also Section II.L of this release for a more detailed discussion of this proposal.

934 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR 33569-335670 (June 18, 2007).

management perspective by establishing a more automated storage process and creating efficiencies in terms of reducing the volume of paper filings that must be manually processed and stored.

The Commission also is proposing amendments to Rule 314 of Regulation S-T that would permit municipal securitizers of Exchange Act-ABS, or underwriters in the offering of municipal Exchange Act-ABS, to provide the information required by Form ABS-15G on EMMA, the Municipal Securities Rulemaking Board's centralized public database.[935] This would allow investors and other market participants to access the information required in Form ABS-15G along with other information on EMMA about the municipal Exchange Act-ABS.

### 11. Form ID

NRSROs would need to file a Form ID with the Commission in order to gain access to the Commission's EDGAR system to electronically submit Form NRSROs submitted pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports submitted pursuant to Rule 17g-3 through the EDGAR system with the Commission.[936] The use of this information is addressed in Sections IV.D.1, IV.D.4 and IV.A.10 of this release.

## C. RESPONDENTS

In adopting the first rules under the Rating Agency Act of 2006, the Commission estimated that approximately 30 credit rating agencies ultimately would be registered as NRSROs.[937] Since that time, 10 credit rating agencies have registered with the Commission as

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935 See proposed amendments to Rule 314 of Regulation S-T (17 CFR 231.314); see also Section II.H.1 of this release for a more detailed discussion of this proposal.

936 See Section II.L of this release for a more detailed discussion of these proposals.

937 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33607 (June 18, 2007).

NRSROs.[938] This number has remained constant for several years. Consequently, while the Commission expects several more credit rating agencies may become registered as NRSROs over the next few years, the Commission preliminarily believes that the actual number of NRSROs should be used for purposes of the PRA.

The Commission notes the current industry-wide annual burden estimates for the NRSRO Rules are based on 30 respondents. Consequently, these estimates would need to be adjusted to reflect the Commission's use of the actual number of NRSROs (i.e., 10 respondents). In this regard, the current OMB approved industry-wide annual hour burdens are: 6,400 hours for Rule 17g-1 and Form NRSRO; 12,000 hours for Rule 17g-2; 7,900 hours for Rule 17g-3; and 96,948 hours for Rule 17g-7. Adjusting for 10 respondents, these industry-wide annual hour burdens would be: 2,133 hours for Rule 17g-1 and Form NRSRO;[939] 4,000 hours for Rule 17g-2;[940] 2,633

938 A.M. Best Company, Inc., DBRS Ltd., Egan-Jones Rating Company, Fitch, Inc., Japan Credit Rating Agency, Ltd., Kroll Bond Rating Agency, Inc. (formerly LACE Financial Corp.), Moody's Investors Service, Inc., Rating and Investment Information, Inc., Realpoint LLC, and Standard & Poor's Ratings Services.

939 The current OMB approved total industry-wide annual hour burden for Rule 17g-1 and Form NRSRO of 6,400 hours is based on 30 respondents preparing and filing Form NRSROs. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33607-33609 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6470 (Feb. 9, 2009), and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63889-63890 (Dec. 4, 2009). Consequently, the adjusted current industry-wide annual hour burden for Rule 17g-1 and Form NRSRO would be 2,133 hours (6,400 hours/30 NRSROs = 213 hours; 10 NRSROs x 213 hours = 2,133 hours).

940 The current OMB approved total industry-wide annual hour burden for Rule 17g-2 of 12,000 hours is based on 30 respondents making and retaining the required records identified in paragraphs (a) and (b) of Rule 17g-2 and making the required disclosures in paragraphs (d)(2) and (d)(3) (except the hour burden resulting from paragraph (d)(2) of Rule 17g-2 was allocated across 7 NRSROs; however, the impact on the per firm total of allocating to 7 as opposed to 10 firms is minimal). See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33609-33610 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6473 (Feb. 9, 2009), and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63888-63889 (Dec. 4,

hours for Rule 17g-3;[941] and 92,948 hours for Rule 17g-7.[942] For the purposes of the PRA discussion below and the economic analysis in Section V of this release, the Commission uses the adjusted current industry-wide annual hour burdens above (the "adjusted industry-wide annual hour burdens"). For example, when discussing how a proposed amendment would increase an industry-wide annual hour burden, the Commission adds the increased hour burden to the applicable rule's adjusted current industry-wide annual hour burden.

The Commission preliminarily believes there are approximately 10 firms that provide, or would begin providing, third-party "due diligence services" to issuers and underwriters of Exchange Act-ABS as the term "due diligence services" would be defined in paragraph (a) of proposed new Rule 17g-10.[943] As discussed in Section II.H.2 of this release, the Commission

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2009). Consequently, the adjusted current industry-wide annual hour burden for Rule 17g-2 would be 4,000 hours (12,000 hours/30 NRSROs = 400 hours; 10 NRSROs x 400 hours = 4,000 hours).

941 The current OMB approved total industry-wide annual hour burden for Rule 17g-3 of 7,900 hours is based on 30 respondents preparing and filing the annual reports. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33610 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6473 (Feb. 9, 2009), and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63888-63889 (Dec. 4, 2009). Consequently, the adjusted current industry-wide annual hour burden for Rule 17g-3 would be 2,633 hours (7,900 hours/30 NRSROs = 263 hours; 10 NRSROs x 263 hours = 2,633 hours).

942 Of the 96,948 hours in the current OMB approved total industry-wide annual hour burden for Rule 17g-7, 90,948 hours are based on the number of Exchange Act-ABS transactions per year for which the disclosure requirement in the rule would apply (i.e., not based on the number of respondents). See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4508 (Jan. 26, 2011). However, 6,000 hours in that total are based on the number of respondents. Id. Consequently, the adjusted current industry-wide annual hour burden for Rule 17g-7 would be 92,948 hours (6,000 hours/30 NRSROs = 200 hours; 10 NRSROs x 200 hours = 2,000 hours; 90,948 hours + 2,000 hours = 92,948 hours).

943 See, e.g., Testimony of Vicki Beal, Senior Vice President, Clayton Holdings, before the Financial Crisis Inquiry Commission (Sept. 23, 2010).

preliminarily believes that the firms providing third-party "due diligence services" as that term would be defined in proposed new Rule 17g-10 concentrate mostly on providing such services for RMBS. Consequently, given the low issuance rate for RMBS, the number of active firms may be small but it could grow if issuance volume increases.

The Commission preliminarily believes there are 270 unique securitizers that would be subject to the proposed requirements in new Rule 15Ga-2 and the amendments to Form ABS-15G.[944] This estimate is based on the Commission's estimate of the number of securitizers that would be subject to requirements in Rule 15Ga-1 and Form ABS-15G.[945]

Request for Comment

The Commission generally requests comment on all aspects of these estimates of the number of respondents. In addition, the Commission requests specific comments on the following:

1. Is it reasonable for the Commission to use the actual number of NRSROs for purposes of the PRA? Alternatively, should the Commission either use, for purposes of the PRA, the estimate of 30 NRSROs it has used in the past or develop and use a new estimate of the expected eventual number of NRSROs? Explain any choices made with respect to the number of NRSROs that should be used for the purposes of the PRA, including any data and analysis supporting the choice.
2. Identify any sources of industry information that could be used to estimate the number of NRSROs that may become registered with the Commission over the next few years for purposes of the PRA.

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944 See proposed new Rule 15Ga-2 and the amendments to Form ABS-15G; see also Section II.H.1 of this release for a more detailed discussion of this proposal.

945 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4506-4507 (Jan. 26, 2011)

3. Is the estimate that 10 firms will be operate as third-party "due diligence service" providers over the next few years reasonable? Alternatively, should the Commission use some other number? Explain any choices made with respect to the number of third-party "due diligence service" providers that should be used for the purposes of the PRA, including any data and analysis supporting the choice.
4. Identify any sources of industry information that could be used to estimate the number of third-party "due diligence service" providers for purposes of the PRA.

### D. TOTAL INITIAL AND ANNUAL RECORDKEEPING AND REPORTING BURDENS

Unless otherwise noted, the one-time and annual hour burden estimates per NRSRO described below are averages across all types of NRSROs that would be subject to the proposed amendments and new rules. The NRSROs vary, in terms of size and complexity, from small entities that employ less than 20 credit analysts to complex global organizations that employ over a thousand credit analysts.[946] Given the variance in size between the largest NRSROs and the smallest NRSROs, the burden estimates, as averages across all NRSROs, are skewed higher because the largest firms currently dominate in terms of size and the volume of credit rating issuance.[947]

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946 See, e.g., Annual Report on Nationally Recognized Statistical Rating Organizations. Commission (Jan. 2011), pp. 4-9.

947 Based on data collected from the NRSROs in their Form NRSROs and Rule 17g-3 annual reports, the Commission has used the Herfindahl-Hirschmann Index (HHI) to analyze market concentration among the 10 NRSROs. Id. HHI is calculated by squaring the market share of each firm competing in the market and then summing the resulting number. Id. The HHI is measured on a scale of 0 to 10,000 and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases. Id. According to the U.S. Department of Justice, markets in which the HHI is between 1,000 and 1,800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1,800 points are considered to be concentrated.

As discussed below, with respect to some burden estimates, the Commission preliminarily believes it would be reasonable to use the approximate number of credit ratings outstanding or the number of credit analysts employed based on the most recently submitted annual certifications of the NRSROs.[948] These data are presented in Figure 2 and Figure 3 below, respectively.

**Figure 2**
**Outstanding Credit Ratings Reported by NRSROs on Form NRSRO by Ratings Class**

| NRSRO | Financial Institutions | Insurance Companies | Corporate Issuers | Asset-Backed Securities | Government, Municipal & Sovereign | Total Ratings |
|---|---|---|---|---|---|---|
| A.M. Best | 3 | 5,364 | 2,246 | 54 | 0 | 7,667 |
| DBRS | 16,630 | 120 | 5,350 | 8,430 | 12,400 | 42,930 |
| EJR | 82 | 45 | 853 | 14 | 13 | 1,007 |
| Fitch | 72,311 | 4,599 | 12,613 | 69,515 | 352,697 | 511,735 |
| JCR | 156 | 31 | 518 | 64 | 53 | 822 |
| Kroll | 17,263 | 60 | 1,000 | 0 | 61 | 18,384 |
| Moody's | 76,801 | 5,455 | 31,008 | 106,337 | 862,240 | 1,081,841 |
| R&I | 100 | 30 | 543 | 186 | 123 | 982 |
| Realpoint | 0 | 0 | 0 | 8,856 | 0 | 8,856 |
| S&P | 52,500 | 8,600 | 41,400 | 124,600 | 1,004,500 | 1,231,600 |
| Total | 235,846 | 24,304 | 95,531 | 318,056 | 2,232,087 | 2,905,824 |
| HHI | 2,599 | 2,601 | 3,145 | 3,145 | 3,767 | 3,495 |
| HHI Inverse | 3.85 | 3.84 | 3.18 | 3.18 | 2.65 | 2.86 |

**Figure 3 - Credit Analysts Employed Reported by NRSROs on Form NRSRO**

| NRSRO | Credit | Credit |
|---|---|---|

Id. The Commission has calculated an HHI number using the number credit ratings outstanding per NRSRO and that number is 3,495, which is equivalent to there being approximately 2.86 equally sized firms. Id. The HHI using earnings reported by NRSROs in the Rule 17g-3 annual reports is 3,926, which the equivalent of 2.55 equally sized firms. Id. The inverse of the HHI ("HHI Inverse") is a measure of the number of equally sized firms which would constitute a comparable level of concentration for a given HHI and is calculated by dividing 10,000 by the HHI. Id.

948 See, Annual Report on Nationally Recognized Statistical Rating Organizations. Commission (Jan. 2011), pp. 4-9.

| | Analysts | Analyst Supervisors |
|---|---|---|
| A.M. Best | 134 | 42 |
| DBRS | 67 | 20 |
| EJR | 5 | 3 |
| Fitch | 1,035 | 345 |
| JCR | 61 | 27 |
| Kroll | 7 | 4 |
| Moody's | 1,096 | 143 |
| R&I | 81 | 6 |
| Realpoint | 15 | 7 |
| S&P | 1,019 | 223 |
| Total | 3,520 | 820 |

### 1. Proposed Amendments to Rule 17g-1

The Commission is proposing several amendments to Rule 17g-1. As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

The Commission proposes amending paragraph (i) of Rule 17g-1 to require that an NRSRO make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website.[949] The proposed amendment would remove the option for an NRSRO to make the Form publicly available "through another comparable, readily accessible means" as an alternative to Internet website disclosure. The Commission preliminarily estimates that there would be a minimal one-time hour burden attributable to requiring that an NRSRO make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website and removing the option for an NRSRO to make its Form NRSRO and Exhibits 1 through 9 available through another comparable, readily accessible means. Currently, all NRSROs make Form NRSRO and Exhibits 1 through 9

949 See proposed amendments to paragraph (i) of Rule 17g-1; see also Section II.E.1.b of this release for a more detailed discussion of this proposal.

available on their corporate Internet websites.[950] However, as noted earlier, the Commission preliminarily believes that a Form NRSRO and Exhibits 1 through 9 would be "easily accessible" if they could be accessed through a clearly and prominently labeled hyperlink on the home page of the NRSRO's corporate Internet website. All NRSROs would need to make changes to their corporate Internet websites to place clearly and prominently labeled hyperlinks on the websites to Form NRSRO and Exhibits 1 through 9. Based on staff experience, the Commission preliminarily estimates that re-configuring a corporate Internet website for this purpose would take an average of approximately 5 hours. For these reasons, the Commission preliminarily estimates that the proposed requirement would result in an average one-time hour burden to each NRSRO of approximately 5 hours, resulting in an average one-time industry-wide hour burden of approximately 50 hours.[951] The Commission preliminarily estimates that NRSROs would prepare these responses internally using their own corporate Internet website administrators. The Commission preliminarily does not believe the proposed requirement would result in an increase in the industry-wide annual hour burden attributable to Rule 17g-1 and Form NRSRO.

The Commission also is proposing to amend paragraph (i) of Rule 17g-1 to require that Exhibit 1 be made freely available in writing when requested. This would implement rulemaking mandated in Section 15E(q)(2)(D) of the Exchange Act.[952] With respect to making Exhibit 1 freely available in writing, the Commission notes that, under the proposed amendments to paragraph (i) of Rule 17g-1, Form NRSRO and Exhibits 1 through 9 would need to be made

950 See, e.g., Annual Report on Nationally Recognized Statistical Rating Organizations. Commission (Jan. 2011), pp. 18-19.

951 10 NRSROs x 5 hours = 50 hours.

952 See 15 U.S.C. 78o-7(q)(2)(D).

freely available on an easily accessible portion of the NRSRO's corporate Internet website. Moreover, as noted above, NRSROs currently comply with paragraph (i) of Rule 17g-1 by making their Form NRSROs and Exhibits 1 through 9 available on their corporate Internet websites. Consequently, an individual with access to the Internet and a printer can (and would be able to) obtain Exhibit 1 immediately through the Internet and could print the Exhibit if the individual wanted to have it in paper form. Therefore, the Commission preliminarily estimates that the instances in which an individual would request an NRSRO to provide a written copy of Exhibit 1 would be rare, given that the individual would need to wait for the request to be processed by the NRSRO and the Exhibit to arrive by mail as opposed to accessing it immediately via the Internet. Nonetheless, the Commission preliminarily estimates that some number of individuals may request an NRSRO to provide Exhibit 1 in writing.

The Commission preliminarily estimates that the proposed requirement would result in a one-time hour burden to each NRSRO as they would need to establish procedures and protocols for receiving and processing these requests. Based on staff experience, the Commission preliminarily estimates that each NRSRO would spend an average of approximately 48 hours establishing such procedures and protocols, resulting in an average industry-wide one-time hour burden of approximately 480 hours.[953]

In terms of annual hour burden, the Commission notes it is difficult to quantify the number of requests an NRSRO would receive each year. However, the Commission preliminarily estimates each NRSRO would an average receive of approximately 200 requests per year and would spend an average of 20 minutes processing each request. The estimate of 200 requests is intended to serve as a "placeholder" for PRA purposes and the Commission will

953 10 NRSROs x 48 hours = 480 hours.

revise this estimate based on information provided by NRSROs and other commenters. For these reasons, the Commission estimates that the average annual hour burden to each NRSRO would be approximately 67 hours,[954] resulting in a total industry-wide annual hour burden of approximately 670 hours.[955] The Commission preliminarily estimates that NRSROs would prepare these responses internally.

The Commission also is proposing to amend paragraphs (e), (f), and (g) of Rule 17g-1 to require that an NRSRO use the Commission's EDGAR system to electronically submit Form NRSRO and Exhibits 1 through 9 with the Commission pursuant to these paragraphs in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.[956] NRSROs currently submit these documents to the Commission in paper form.

The Commission preliminarily estimates that each NRSRO would spend an average of approximately 5 hours becoming familiar with the EDGAR filing system and completing and submitting Form ID, which is necessary to access the system. As discussed below, the Commission preliminarily estimates that the one-time hour burden for each NRSRO to complete Form ID would be 15 minutes.[957] In addition, as discussed above and below, the Commission is proposing that the Rule 17g-3 annual report also be submitted using the EDGAR system.[958] The Commission's preliminary estimate of 5 hours to become familiar with the EDGAR system would include developing an understanding of how to use the system for both submitting Form

954 200 requests x 20 minutes per request = 67 hours per year.

955 10 NRSROs x 67 hours per year = 670 hours per year.

956 See proposed amendments to paragraphs (e), (f), and (g) of Rule 17g-1; see also Section II.L of this release for a more detailed discussion of these proposals.

957 See Section IV.D.11 of this release.

958 See proposed amendments to Regulation S-T and Rule 17g-3; see also Section II.L of this release for a more detailed discussion of this proposal.

NRSROs and submitting the Rule 17g-3 annual reports. Consequently, for purposes of the PRA and the Economic Analysis in Section V of this release, the Commission is allocating this one-time hour burden and corresponding cost solely to Rule 17g-1. In addition, because the hour burden of 15 minutes for Form ID is addressed below, the Commission estimates that each NRSRO would spend an average of 4.75 hours becoming familiar with how to use the EDGAR system, resulting in an industry-wide one-time hour burden of approximately 47.5 hours.[959]

The Commission does not believe changing the method of submitting Form NRSRO and Exhibits 1 through 9 from a paper submission to an electronic submission would increase the current annual hour burden for Rule 17g-1. In particular, the Commission believes that the both the amount of time it currently takes an NRSRO to send these materials, once compiled, to the Commission's headquarters by mail, messenger, or hand-delivery by a representative of the NRSRO and the time it would take to submit them electronically through the EDGAR system are de minimus.

For the foregoing reasons, the Commission estimates that the total industry-wide one-time hour burden resulting from the proposed amendments to Rule 17g-1 would be approximately 577.5 hours[960] and the total industry-wide annual burden would be approximately 670 hours.[961]

### 2. **Proposed Amendments to Form NRSRO Instructions**

959 10 NRSROs x 4.75 hours = 47.5 hours.

960 480 hours + 50 + 47.5 hours = 577.5 hours.

961 This estimate would increase the adjusted industry-wide annual hour burden for Rule 17g-1 and Form NRSRO from 2,133 hours to 2,803 hours (2,133 hours + 670 hours = 2,803 hours).

The Commission is proposing to amend the instructions for Exhibit 1 to Form NRSRO.[962] The amendments would confine the disclosures in the Exhibit to transition and default rates and certain limited supplemental information.[963] Moreover, the amendments would standardize the production and presentation of the transition and default statistics. As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

The Commission notes that an NRSRO currently is required to provide transition and default rates in Exhibit 1 for each class of credit rating for which it is registered and for 1, 3, and 10-year periods. The Commission preliminarily estimates that an NRSRO would use the internal information technology systems and expertise and other resources it currently devotes to processing the information necessary to monitor credit ratings and calculate transition and default statistics in order to program a system to comply with the proposed amendments to the Instructions for Exhibit 1. At the same time, the Commission notes that, under the proposed amendments, NRSROs would be required to adhere to specific requirements that may not be the same as their current methods for calculating and presenting transition and default rates. Consequently, the Commission preliminarily estimates that the proposed amendments requiring standardized Transition/Default Matrices would result in a one-time hour burden to program existing systems to create the Transition/Default Matrices that would be required under the proposed amendments and an increase in the annual hour burden to comply with the proposed instructions to Exhibit 1.

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962 See Instruction H to Form NRSRO (as it relates to Exhibit 1).

963 See proposed amendments to the instructions for Exhibit 1 to Form NRSRO (17 CFR 249b.300); see also Section II.E.1.a of this release for a more detailed discussion of this proposal.

As noted above, the size and complexity of the NRSROs varies greatly. The magnitude of this variance is reflected in the number of credit ratings each NRSRO has outstanding.[964] For example, two NRSROs have over 1,000,000 credit ratings outstanding in the classes of credit ratings for which they are registered; others have fewer than 1,000 such ratings.[965] The hour burden associated with calculating and presenting these performance statistics would depend in large part on the number of obligors, securities, and money market instruments assigned credit ratings by the NRSRO.[966] Consequently, the one-time and annual burdens per NRSRO would vary widely.

In order to account for this variance, the Commission preliminarily believes that the one-time and annual hour burden estimates should be based on the number of credit ratings outstanding. Based on the annual certifications submitted by the NRSROs for the 2009 calendar year-end, there were approximately 2,905,824 credit ratings outstanding across all 10 NRSROs.[967] The Commission preliminarily estimates that the one-time industry-wide hour burden to establish systems to process the relevant information necessary to calculate the

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964 See Figure 2 in Section IV.D of this release.

965 Id.

966 For example, as discussed in more detail in Section II.E.1.a of this release, the applicant or NRSRO, in producing a Transition/Default Matrix, would need to determine a start-date cohort consisting of the obligors, securities, and money market instruments in the applicable class or subclass of credit ratings that were assigned a credit rating that was outstanding as of the start date for the applicable period (i.e., the date 1, 3, or 10 years prior to the most recently ended calendar year). The applicant or NRSRO also would need to group the obligors, securities, and money market instruments in the start-date cohort based on the credit rating assigned to them as of the start date and determine the outcome for each such obligor, security, and money market instrument in the group during, or as of the end of, the relevant period. This exercise would be more time-consuming for an NRSRO that has over 1,000,000 credit ratings outstanding than for an NRSRO that has fewer than 10,000 credit ratings outstanding (2 NRSROs have over 1,000,000 credit ratings outstanding and 5 NRSROs have fewer than 10,000 credit ratings outstanding). See Figure 2 in Section IV.D of this Release.

967 Id.

Transition/Default Matrices and make the necessary calculations would be approximately 3 seconds per outstanding credit rating, which would result in a one-time industry-wide hour burden of approximately 2,420 hours.[968] Moreover, because of the wide variance in the number of credit ratings outstanding among the NRSROs, the Commission preliminarily estimates that this one-time hour burden of 2,420 hours would be allocated to the 10 NRSROs based on the number of credit ratings each has outstanding (although larger NRSROs may realize economies of scale). For example, the two largest NRSROs had just over 1,000,000 credit ratings outstanding, the next largest had approximately 500,000 credit ratings outstanding, and the remaining 7 NRSROs had amounts ranging from 42,930 credit ratings outstanding to 982 credit ratings outstanding.[969]

The Commission preliminarily believes that the annual hour burden to comply with the proposed amendments to the Instructions for Exhibit 1 would be less than the one-time hour burden since the NRSROs would have established systems to process the necessary information to produce the required Transition/Default Matrices. Consequently, the Commission preliminarily estimates that the annual hour burden to each NRSRO to calculate the Transition/Default Matrices would be approximately 1.5 seconds per outstanding credit rating, resulting in an industry-wide annual hour burden of approximately 1,210 hours.[970] Moreover, although larger NRSROs may realize economies of scale, the Commission preliminarily estimates that the industry-wide annual hour burden of 1,210 hours would be allocated to each NRSRO based on the number of credit ratings the firm had outstanding.[971]

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968 2,905,824 credit ratings x 3 seconds = 2,421.52 hours (rounded to 2,420 hours).

969 See Figure 2 in Section IV.D of this release.

970 2,905,824 credit ratings x 1.5 seconds = 1,210.76 hours (rounded to 1,210 hours).

971 See Figure 2 in Section IV.D of this release.

For the foregoing reasons, the Commission estimates that the total industry-wide one-time hour burden resulting from the proposed amendments to the instructions for Exhibit 1 to Form NRSRO would be approximately 2,420 hours and the total industry-wide annual burden would be approximately 1,210 hours.[972]

### 3. Proposed Amendments to Rule 17g-2

The Commission proposes adding paragraph (a)(9) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Exchange Act and proposed paragraph (c) of Rule 17g-8 as a record that must be made and retained.[973] In addition, the Commission is proposing to add the following new paragraphs to Rule 17g-2 to identify records that must be retained: (1) paragraph (b)(12) would identify the internal control structure an NRSRO must establish, maintain, enforce, and document pursuant to Section 15E(c)(3)(A);[974] (2) paragraph (b)(13) would identify the policies and procedures an NRSRO is required to establish, maintain, enforce, and document pursuant to

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972 These estimates would increase the adjusted industry-wide annual hour burden for Rule 17g-1 and Form NRSRO from 2,133 hours to 3,343 hours (2,133 hours + 1,210 hours = 3,343 hours). Combined with the industry-wide annual burden hour increase of 670 hours resulting from the proposed amendments to Rule 17g-1 discussed above in Section IV.D.2 of this release, the total increase to the adjusted industry-wide annual hour burden for Rule 17g-1 and Form NRSRO would be from 2,133 hours to 4,013 hours (2,133 + 670 hours + 1,210 hours = 4,013 hours). The Commission notes that the adjusted industry-wide annual hour burden for all of Rule 17g-1 and Form NRSRO (which includes providing the transition and default rates required in Exhibit 1 under the existing instructions) is 2,133 hours. Consequently, the Commission preliminarily believes these estimates of the incremental burden that would result from the proposed amendments to the Instructions for Exhibit 1 are conservatively large.

973 See proposed new paragraph (a)(9) to Rule 17g-2(a)(9); see also Section II.C.2 of this release for a more detailed discussion of this proposal.

974 See proposed new paragraph (b)(12) of Rule 17g-2; see also Section II.A.2 of this release for a more detailed discussion of this proposal.

proposed paragraph (a) of new Rule 17g-8;[975] (3) paragraph (b)(14) would identify the policies and procedures an NRSRO must establish, maintain, enforce, and document pursuant to proposed paragraph (b) of new Rule 17g-8;[976] and (4) paragraph (b)(15) would identify the standards of training, experience, and competence for credit analysts an NRSRO must establish, maintain, enforce, and document pursuant to proposed new Rule 17g-9.[977] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

The Commission is providing preliminary estimates below in Section IV.D.5 of this release of the one-time and annual hour burdens that would result from establishing, maintaining, enforcing, and documenting the policies and procedures required by Section 15E(h)(4)(A) of the Exchange Act and proposed paragraph (c) of Rule 17g-8. Because the requirement to document these procedures would be the same as the requirement in proposed paragraph (a)(9) of Rule 17g-2 to make this record, the PRA burdens associated with that aspect of the making of the record are addressed below in Section IV.D.5 of this release.

Consequently, for the purposes of Rule 17g-2, the Commission is providing preliminary estimates of the one-time and annual hour burdens resulting from the requirement to retain the records that would be identified in new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2. The Commission preliminarily estimates that the one-time hour burden would result from the NRSRO needing to update its record retention policies and procedures to incorporate

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975 See proposed new paragraph (b)(13) to Rule 17g-2; see also Section II.F.2 of this release for a more detailed discussion of this proposal.

976 See proposed new paragraph (b)(14) to Rule 17g-2; see also Section II.J.2 of this release for a more detailed discussion of this proposal.

977 See proposed new paragraph (b)(15) to Rule 17g-2; see also Section II.I.2 of this release for a more detailed discussion of this proposal.

these new records that would need to be retained. Based on staff experience, the Commission preliminarily estimates that each NRSRO would spend an average of approximately 20 hours updating its record retention policies and procedures, resulting in an industry-wide one-time hour burden of approximately 200 hours.[978]

In terms of annual hour burden, the Commission notes that the adjusted industry-wide annual hour burden attributable to Rule 17g-2 is 4,000 hours, resulting in an average annual burden of 400 hours per NRSRO.[979] This burden amount is attributable to 8 different types of records that must be made and retained by the NRSRO, 11 types of records that must be retained if made or received, and to the disclosure requirements in paragraphs (d)(2) and (d)(3) of Rule 17g-2.[980] The Commission preliminarily believes that most of the hour burden is attributable to making the records identified in paragraph (a) of the Rule 17g-2 and making the disclosures required in paragraph (d) of Rule 17g-2 as this work is substantially more labor intensive than retaining a record. Consequently, the Commission preliminarily estimates that the burden associated with retaining the 5 new records that would be identified in new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2 would be minimal because NRSROs already should have well-established procedures with respect to the records they must make and retain pursuant to Rule 17g-2. In addition, the Commission does not expect the new records would change frequently given that they would be the NRSRO's internal control structure required pursuant to Section 15E(c)(3)(A) of the Exchange Act,[981] various types of policies and procedures, and the standards of training, experience, and competence for credit analysts an

978 10 NRSROs x 20 hours = 200 hours.

979 4,000 hours/10 NRSROs = 400 hours.

980 See 17 CFR 240.17g-2(a), (b), (d)(2), and (d)(3).

981 See 15 U.S.C. 78o-7(c)(3)(A).

NRSRO must establish, maintain, enforce, and document pursuant to proposed new Rule 17g-9. Accordingly, once the original record is retained, the need to expend resources to retain updated versions of the original record would be infrequent. Therefore, the Commission preliminarily estimates that it would take approximately one hour per record each year to retain updated versions of these records. For these reasons, the Commission preliminarily estimates that the annual hour burden for each NRSRO attributable to these proposals would be approximately 5 hours,[982] resulting in an industry-wide annual hour burden of approximately 50 hours.[983]

The Commission is proposing to repeal paragraph (d)(2) of Rule 17g-2 and re-codify and enhance the requirements in paragraph (d)(3) of Rule 17g-2 in proposed new paragraph (b) of Rule 17g-7.[984] The Commission preliminarily estimates that the repeal and re-codification would result in de minimis one-time hour burdens to each NRSRO.[985] The one-time and annual hour burden resulting from the proposed enhancements to the requirements currently codified in paragraph (d)(3) are discussed below in Section V.D.4 of this release, which addresses the one-time and annual hour burdens resulting from the proposed amendments to Rule 17g-7.

For the foregoing reasons, the Commission estimates that the total industry-wide one-time hour burden resulting from the proposed amendments to Rule 17g-2 would be

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982 5 records x 1 hour = 5 hours.

983 10 NRSROs x 5 hours = 50 hours.

984 See proposed amendments to paragraphs (d)(2) and (3) of Rule 17g-2 and proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

985 For example, each NRSRO likely would remove the disclosures required pursuant to paragraph (d)(2) Rule 17g-2 from its corporate Internet websites (though such a removal would not be mandatory).

approximately 200 hours and the total industry-wide annual hour burden would be approximately 50 hours.[986]

#### 4. Proposed Amendments to Rule 17g-3

The Commission proposes amending paragraphs (a) and (b) of Rule 17g-3 to implement the rulemaking mandated by Section 15E(c)(3)(B) of the Exchange Act.[987] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

The proposed amendment to paragraph (a) would add a new paragraph (a)(7) to require an NRSRO to include an additional report – a report on the NRSRO's internal control structure – with its annual submission of reports pursuant to Rule 17g-3. The proposed amendment to paragraph (b) of Rule 17g-3 would require the NRSRO's CEO or, if the firm does not have a CEO, an individual performing similar functions, to provide a signed statement that would be attached to the report. The Commission preliminarily estimates that the proposed amendments would result in one-time and annual hour burdens.

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986 The adjusted industry-wide annual hour burden for Rule 17g-2 is 4,000 hours. The elimination of the requirements in paragraph (d)(2) of Rule 17g-7 would subtract 70 hours from that amount. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6472 (Feb. 9, 2009). In addition, the re-codification of paragraph (d)(3) of Rule 17g-2 in proposed new paragraph (b) of Rule 17g-7 would subtract an additional 450 hours from the adjusted industry-wide annual hour burden for Rule 17g-2. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63853 (Dec. 4, 2009). Consequently, after these subtractions, the adjusted industry-wide annual hour burden for Rule 17g-2 would be 3,480 hours (4,000 hours - 70 hours - 450 hours = 3,480 hours). The proposed amendments to add paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) to Rule 17g-2 would, as discussed above, add approximately 50 hours to the adjusted industry-wide annual hour burden resulting in a total adjusted industry-wide annual hour burden of 3,530 hours (3,480 hours + 50 hours = 3,530 hours).

987 See proposed new paragraphs (a)(7) and (b)(2) of Rule 17g-3; see also Section II.A.3 of this release for a for a more detailed discussion of this proposal.

The Commission notes that NRSROs already should have developed processes and protocols to prepare the annual reports required by Rule 17g-3. Consequently, the Commission preliminarily estimates that the internal hour burden associated with the first submission of the report would not be materially different than the hour burden associated with submitting subsequent reports, although the time required to prepare subsequent reports could decrease incrementally over time as the NRSRO gains experience with the requirement. The Commission, however, preliminarily estimates that an NRSRO likely would engage outside counsel to analyze the requirements for the report and assist in drafting and reviewing the first report, given that it must be signed by the NRSRO's CEO or an individual performing a similar function. The time an outside attorney would spend on this work would depend on the size and complexity of the NRSRO. The Commission preliminarily estimates that an attorney would spend an average of approximately 100 hours assisting an NRSRO and its CEO or other qualified individual in drafting and reviewing the first report, resulting in an industry-wide external one-time hour burden of approximately 1,000 hours.[988] Based on industry sources, the Commission estimates that the cost of an outside counsel would be approximately $400 per hour.[989] For these reasons, the Commission estimates that the average one-time cost to an

[988] 10 NRSROs x 20 hours = 200 hours.

[989] See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour to engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

NRSRO would be approximately $40,000,[990] resulting in an industry-wide one-time cost of approximately $400,000.[991]

The Commission preliminarily estimates, based on staff experience, that each NRSRO would spend on average approximately 150 hours preparing the internal control report to be included with the other annual reports filed with the Commission, resulting in an industry-wide annual burden of approximately 1,500 hours.[992]

In addition, the Commission preliminarily estimates that an NRSRO likely would continue to engage outside counsel to assist in preparing the report. As noted above, the time an outside attorney would spend on this work would depend on the size and complexity of the NRSRO. In addition, the Commission preliminarily estimates that the time an outside attorney would spend assisting in the preparation of subsequent reports would be less than the time spent on preparing the first report since the counsel's work would not need to include an initial analysis of the new requirements. Consequently, the Commission estimates that an attorney would spend an average of approximately 50 hours assisting an NRSRO and its CEO or other qualified individual in drafting and reviewing the report, resulting in an industry-wide annual hour burden of approximately 500 hours.[993] As stated above, the Commission estimates that the cost of an outside counsel would be approximately $400 per hour. For these reasons, the Commission estimates that the average annual cost to an NRSRO to comply with this

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990 100 hours x $400 = $40,000. See also, Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an attorney).

991 10 NRSROs x $40,000 = $400,000.

992 10 NRSROs x 150 hours = 1,500 hours.

993 10 NRSROs x 20 hours = 200 hours.

requirement would be approximately $20,000,[994] resulting in an industry-wide annual cost of approximately $200,000.[995]

The amendments also would require that the Rule 17g-3 annual reports be submitted electronically on the Commission's EDGAR system.[996] As discussed in Section IV.D.1 of this release, the Commission preliminarily estimates each NRSRO would spend 5 hours becoming familiar with how to use the EDGAR system and to complete Form ID for the purposes of submitting Form NRSRO (and Exhibits 1 through 9) and the Rule 17g-3 annual reports. For the purposes of this PRA and the Economic Analysis section below, the Commission is allocating that time to Rule 17g-1 and Form ID.

In addition, the Commission does not believe that changing the method of submitting the annual reports from a paper submission to an electronic submission would increase the current hour burden for Rule 17g-3. For example, the Commission does not believe the amount of time it currently takes an NRSRO to gather these materials and send them to the Commission's headquarters by mail, messenger, or hand-delivery would be less than the time it would take to submit them electronically through the EDGAR system.

For the foregoing reasons, the Commission preliminarily estimates that the proposed amendments to Rule 17g-3 would result in a total industry-wide one-time cost of approximately

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994 50 hours x $400 = $20,000. See also, Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an attorney).

995 10 NRSROs x $20,000 = $200,000.

996 See proposed new paragraph (d) of Rule 17g-3; see also Section II.L of this release for a more detailed discussion of this proposal.

$400,000, a total industry-wide annual hour burden of approximately 1,500 hours, and a total industry-wide annual cost of approximately $200,000.[997]

### 5. Proposed New Rule 17g-7

The Commission is proposing to add new paragraphs (a) and (b) to Rule 17g-7, which would contain substantial new requirements.[998] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

The Commission is proposing to add new paragraphs (a)(1) and (2) to Rule 17g-7 to implement rulemaking mandated in Sections 15E(s)(1), (2), (3), and (4)(D) of the Exchange Act.[999] Proposed new paragraphs (a)(1) and (2) of Rule 17g-2 would require, respectively, an NRSRO, when taking a rating action, to publish a form containing information about the credit rating resulting from, or subject to, the rating action and any certification of a provider of third-party due diligence services received by the NRSRO relating to the credit rating.[1000]

The Commission preliminarily believes that much of the information required to be disclosed in the form could be standardized based on the class and subclass of credit rating. For example, an NRSRO could develop a set of standardized disclosures for structured finance products based on whether the credit rating was issued for an RMBS, CMBS, CDO, CLO, ABCP, or other type of structured finance product. Similarly, for corporate issuers, the NRSRO could develop a set of standardized disclosures depending on factors such as the industry sector

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997 This estimate would increase the adjusted industry-wide annual hour burden for Rule 17g-3 from 2,633 hours to 4,133 hours.

998 17 CFR 240.17g-7.

999 See 15 U.S.C. 78o-7(s)(1), (2), (3), and (4)(D) and proposed new paragraph (a) of Rule 17g-7; see also Sections II.G.1 through G.5 of this release for a more detailed discussion of this proposal.

1000 See proposed new paragraphs (a)(1) and (2) of Rule 17g-7.

and geographic location of the rated issuer. In addition, the Commission believes that much of the information, particularly as it relates to the specific obligor, security, or money market instrument that is subject to the rating action, already would be generated or collected through the credit rating process. Finally, the Commission notes that globally active NRSROs are subject to similar requirements.[1001]

Consequently, the Commission estimates that the proposal would result in a one-time hour burden to develop the standardized disclosures and to create systems, protocols, and procedures for populating the form with information generated and collected during the rating process. In addition, the NRSRO would need to develop procedures designed to ensure that all the information required to be included in the form is input into the form prior to the publication of the credit rating, that any certifications received from a provider of third-party due diligence services are attached to the form, and that the form and certifications are published with the credit rating.

The Commission preliminarily estimates that the one-time hour burden to develop these standardized disclosures would vary considerably among NRSROs based on the number of credit ratings they issue and monitor and the number of classes and subclasses of credit ratings for which they issue and monitor credit ratings. Specifically, the larger NRSROs that issue and monitor a high volume of credit ratings across multiple classes and subclasses of credit ratings would bear a significantly greater burden than smaller NRSROs that may need to develop standardized disclosures for far fewer classes and subclasses of credit ratings. The Commission estimates that an NRSRO would spend an average of approximately 5,000 hours to develop the standardized disclosures and create the systems, protocols, and procedures for populating the

1001 See, e.g., Regulation no. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, Article 8.2 and Annex I, Section D.

form with information generated and collected during the rating process.[1002] However, the Commission preliminarily estimates that this amount is heavily skewed upward by the number of credit ratings issued, as well as the breadth of the classes and subclasses rated, by the three largest NRSROs as compared to the seven smaller NRSROs. Given the 5,000 hours per NRSRO preliminary estimate, the Commission preliminarily estimates that the proposal would result in a one-time industry wide hour burden of approximately 50,000 hours.[1003] In addition, the Commission preliminarily allocates 75% of these burden hours (37,500 hours) to internal burden and the remaining 25% (12,500 hours) to external burden to hire outside professionals to assist in setting up the process to generate the forms and publish them with applicable credit ratings.[1004] The Commission preliminarily estimates $400 per hour for retaining outside professionals such as attorneys and information technology consultants, resulting in an industry-wide one-time cost of approximately $5,000,000.[1005]

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1002 This estimate is based on the Commission's estimate for the amount of time it would take a securitizer to set-up a system to make the disclosures required by Form ABS-15G. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011). The Commission significantly increases the estimate for Form ABS-15G because the form required pursuant to Rule 17g-7 would contain substantially more qualitative information for which the NRSRO would need to develop standardized disclosures.

1003 10 NRSROs x 5,000 hours = 50,000 hours.

1004 50,000 hours x 0.75 = 37,500 hours; 50,000 hours x 0.25 = 12,500 hours. This allocation is based on the Commission's allocation of the industry-wide hour burden for the amount of time it would take a securitizer to set-up a system to make the disclosures required by Form ABS-15G. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011).

1005 12,500 hours x $400 = $5,000,000. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

With respect to the annual hour burden, the Commission preliminarily estimates that the estimate should be divided into two components. The first component would constitute the amount of time an NRSRO would spend to update its standardized disclosures. The Commission preliminarily estimates an NRSRO would spend substantially less time updating the disclosures than the one-time estimate of approximately 5,000 hours per NRSRO to initially establish the standardized disclosures and the systems, protocols, and processes to generate the forms. Consequently, the Commission preliminarily estimates that each NRSRO would spend an average of approximately 500 hours per year updating the standardized disclosures, resulting in an annual industry-wide hour burden of approximately 5,000 hours. The Commission preliminarily estimates that the update process would be handled by the NRSROs internally.

The second component would constitute the amount of time an NRSRO would spend generating and publishing each form and attaching applicable certifications to the form. The Commission preliminarily believes that this estimate should be based on the number of rating actions taken per year by the NRSROs because the requirement to generate and publish the form and attach the certifications would be triggered upon the taking of a rating action. Based on information submitted to the Commission by NRSROs pursuant to paragraph (a)(6) of Rule 17g-3, the Commission preliminarily estimates that NRSROs took approximately 2,000,000 credit rating actions in 2009, consisting of upgrades, downgrades, placements on credit watch, and withdrawals of credit ratings.[1006]

The Commission notes this figure does not include the following rating actions: expected or preliminary credit ratings, initial credit ratings, and affirmations of existing credit ratings.[1007]

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1006 See 17 CFR 240.17g-7(a)(6).

1007 As discussed in more detail Section II.G.1 of this release, the Commission is proposing that the requirement to publish the form and any certifications would be triggered when

Based on staff experience, the Commission preliminarily believes expected or preliminary credit ratings are published primarily (but not exclusively) with respect to new issuances of structured finance products. In the PRA for the adoption of Rule 17g-7, the Commission estimated that there would be an average of approximately 2,067 Exchange Act-ABS offerings per year.[1008] The Commission, based on staff experience, believes expected or preliminary credit ratings are used in other types of offerings as well and, therefore, is increasing that estimate by 100% or to 4,134 preliminary or expected credit ratings per year.[1009]

In terms of estimating the number initial credit ratings, the Commission notes that there were approximately 2,905,824 credit ratings outstanding across all 10 NRSROs as of the 2009 calendar year-end.[1010] Based on staff experience, the Commission estimates that the average maturity of rated securities and money market instruments is approximately 7 years. Consequently, assuming 2,905,824 is the approximate average number of credit ratings outstanding at any given time, the Commission preliminarily estimates that approximately 415,117 initial credit rating are issued per year.[1011]

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an NRSRO takes the following rating actions: publication of an expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating; an initial credit rating; an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default); a placement of an existing credit rating on credit watch or review; an affirmation of an existing credit rating; and a withdrawal of an existing credit rating.

1008 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4508 (Jan. 26, 2011).

1009 2,067 offerings x 2 = 4,134 offerings.

1010 See Figure 2 in Section IV.D of this Release.

1011 2,905,824 credit ratings/7 = 415,117 credit ratings. In other words, the Commission estimates that issuers pay off in full all outstanding principal and interest outstanding with respect to approximately 415,117 rated securities or money market instruments and, consequently, the credit ratings for these securities and money market instruments are withdrawn. Those withdrawn credit ratings, in turn, are replaced by 415,117 initial (or new) credit ratings. The Commission notes that outstanding credit ratings assigned to

Finally, with respect to affirmations of existing credit ratings, the Commission preliminarily believes that NRSROs generally affirm existing credit ratings at least once a year. Consequently, the Commission preliminarily estimates that the number of affirmations would be the total number of credit ratings outstanding (2,905,824), less the number of credit ratings subject to other types of rating actions, excluding expected or preliminary ratings (2,000,000), and less the number of credit ratings assigned to securities or money market instruments that are paid off in full during the year (415,117). Consequently, the Commission preliminarily estimates that the number of affirmations per year is approximately 490,707.[1012]

Based on these estimates, the Commission preliminarily estimates that the 10 NRSROs take approximately 2,909,958 credit rating actions per year.[1013] The Commission preliminarily estimates that the time it would take to generate a form by populating it with the required disclosures and to publish the form with the credit rating would be approximately 15 minutes on average, resulting in an industry-wide annual hour burden of approximately 727,490 hours.[1014] Moreover, although larger NRSROs may realize economies of scale, the Commission

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securities and money market instruments are withdrawn for other reasons, including the security or money market instrument went into default. In addition, the Commission notes that a percent of the outstanding credit ratings are assigned to obligors as entities and, therefore, these credit ratings would not be withdrawn because an obligation was extinguished. However, they might be withdrawn for other reasons, including the obligor went into default. Nonetheless, the Commission preliminarily believes these estimates are reasonable approximations of the number of initial credit ratings determined per year.

1012 [2,905,824 outstanding credit ratings] - [2,000,000 credit ratings that are upgraded, downgraded, placed on watch, or withdrawn] - [415,117 rated securities and money market instruments that pay off in full] = 490,707 affirmations.

1013 [2,000,000 credit rating actions constituting upgrades, downgrades, placements on credit watch, and withdrawals] + [4,134 preliminary or expected credit ratings] + [415,117 initial credit ratings] + [490,707 affirmations of existing credit ratings] = 2,909,958 rating actions per year.

1014 2,909,958 rating actions x .25 hours = 727,489.5 hours (rounded to 727,490 hours).

preliminarily estimates that the annual burden would be allocated to the 10 NRSROs based on the number of credit ratings they have outstanding.[1015]

The Commission also is proposing to add new paragraph (b) to Rule 17g-7. The proposed amendments would: (1) re-codify in paragraph (b) of Rule 17g-7 requirements currently contained in paragraph (d)(3) of Rule 17g-2; and (2) substantially enhance those requirements.[1016] The Commission notes that NRSROs currently are required to provide ratings history information for each credit rating initially determined on or after June 26, 2007. The Commission preliminarily estimates that NRSROs could use the internal information technology systems and expertise and other resources they currently devote to complying with this requirement to implement the proposed enhancements. At the same time, the Commission notes that, under the proposed amendments, NRSROs would be required to add substantially more ratings histories to the disclosures and provide more information about each rating action in the ratings history for a given obligor, security, or money market instrument. Consequently, the Commission preliminarily estimates that the proposed amendments would result in a one-time hour burden to program existing systems and initially add the ratings histories for all outstanding credit ratings as of June 26, 2007, and an incremental increase in the annual hour burden to comply with the enhanced requirements.

When adopting paragraph (d)(3) of Rule 17g-2, the Commission estimated that the average one-time hour burden per NRSRO would be approximately 45 hours.[1017] Based on that estimate, the Commission estimates that the proposed amendments to this disclosure requirement

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1015 See Figure 2 in Section IV.D of this release.

1016 See proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

1017 Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63853 (Dec. 4, 2009).

would result in an average one-time hour burden for each NRSRO of approximately 135 hours, resulting in an industry-wide one-time hour burden of approximately 1,350 hours.[1018] In addition, when adopting paragraph (d)(3) of Rule 17g-2, the Commission estimated the average annual burden per NRSRO would be approximately 15 hours.[1019] Based on that estimate, the Commission preliminarily estimates that the proposed enhancements would require each NRSRO to spend an average of 45 hours per year making the disclosures, resulting in an industry-wide annual hour burden of approximately 450 hours.[1020]

For the foregoing reasons, the Commission estimates that the proposed amendments to Rule 17g-7 would result in a total industry-wide one-time hour burden of approximately 51,350 hours,[1021] a total industry-wide one-time cost of approximately $5,000,000,[1022] and a total industry-wide annual hour burden of approximately 732,940 hours.[1023]

### 6. Proposed New Rule 17g-8

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1018 10 NRSRO x 135 hours = 1,350 hours.

1019 Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63853 (Dec. 4, 2009).

1020 10 NRSRO x 45 hours = 450 hours.

1021 50,000 hours + 1,350 hours = 51,350 hours.

1022 12,500 hours x $400 = $5,000,000.

1023 727,490 hours + 5,000 hours + 450 hours = 732,940 hours. This estimate would increase the adjusted industry-wide annual hour burden for Rule 17g-7 from 92,948 hours to 820,888 hours (732,940 hours + 92,948 = 825,888 hours). In addition, the annual hour burden per NRSRO resulting from the existing requirements in paragraph (d)(3) of Rule 17g-2 is 15 hours, which would result in an adjusted industry-wide annual hour burden of 150 hours (10 NRSROs x 15 hours = 150 hours). This amount would need to be transferred to the industry-wide annual hour burden for Rule 17g-7 resulting in a total industry-wide annual hour burden of 826,038 hours (825,888 hours + 150 hours = 826,038 hours).

The Commission is proposing new Rule 17g-8, which would have three paragraphs (a), (b), and (c).[1024] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

Proposed paragraph (a) of new Rule 17g-8 would implement Section 15E(r) of the Exchange Act by requiring an NRSRO to have policies and procedures with respect to the procedures and methodologies the NRSRO uses to determine credit ratings.[1025] The Commission preliminarily estimates that the proposed requirement in paragraph (a) of new Rule 17g-8 would result in one-time and annual hour burdens for NRSROs. In this regard, the Commission notes that Section 15E(g)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of the NRSRO, to prevent the misuse of material, nonpublic information by the NRSRO or any person associated with the NRSRO.[1026] The Commission supplemented this statutory requirement by adopting Rule 17g-4, which provides that the policies and procedures under Section 15E(g) of the Exchange Act must include policies and procedures reasonably designed to prevent: (1) the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services; (2) a person within the NRSRO from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is aware of material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments; and (3) the inappropriate dissemination

1024 New Rule 17g-8, if adopted, would be codified at 17 CFR 240.17g-8.

1025 See 15 U.S.C. 78o-7(r) and proposed new paragraph (a) of Rule 17g-8; see also Section II.F.1 of this release for a more detailed discussion of this proposal.

1026 See 15 U.S.C. 78o-7(g).

within and outside the NRSRO of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.[1027]

When adopting Rule 17g-4, the Commission assumed NRSROs already had procedures in place to address the specific misuses of material nonpublic information identified in Rule 17g-4.[1028] Nonetheless, the Commission expected that some NRSROs might need to modify their procedures to comply with the rule.[1029] Based on staff experience, the Commission estimated that it would take approximately 50 hours for an NRSRO to establish procedures in conformance with the rule.[1030] Given the specificity of paragraph (a) proposed Rule 17g-8 as well as the fact that unlike the policies and procedures required under Rule 17g-4, the policies and procedures that would be required under paragraph (a) of proposed Rule 17g-8 would not be supplementing policies and procedures that are required under a separate self-executing statutory provision (i.e., the requirement would be based solely on the Commission's rule), the Commission preliminarily believes that paragraph (a) of proposed Rule 17g-8 would result in a greater hour burden for an NRSRO. For these reasons, the Commission preliminarily estimates that an NRSRO would spend an average of approximately 200 hours establishing the policies and procedures, resulting in an industry-wide one-time hour burden of approximately 2,000 hours.[1031] In addition, the Commission preliminarily estimates an NRSRO would spend an average of approximately 50

1027 See 17 CFR 240.17g-4; see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33593-33595 (June 18, 2007).

1028 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33610-33611 (June 18, 2007).

1029 Id.

1030 Id.

1031 10 NRSROs x 200 hours = 2,000 hours.

hours per year reviewing the policies and procedures and updating them (if necessary), resulting in an industry-wide annual hour burden of approximately 500 hours.[1032]

Proposed paragraph (b) of new Rule 17g-8 would implement Section 938(a) of the Dodd-Frank Act by requiring an NRSRO to have policies and procedures with respect to the symbols, numbers, or scores it uses to denote credit ratings.[1033] These policies and procedures would be used by the NRSRO to achieve the objectives specified in Sections 938(a)(1) through (3) of the Dodd-Frank Act.[1034] For the reasons stated above with respect to proposed paragraph (a) of new Rule 17g-8, the Commission estimates that an NRSRO would spend an average of approximately 200 hours establishing the policies and procedures, resulting in an industry-wide one-time hour burden of approximately 2,000 hours.[1035] In addition, the Commission preliminarily estimates an NRSRO would spend an average of approximately 50 hours per year reviewing the policies and procedures and updating them (if necessary), resulting in an industry-wide annual hour burden of approximately 500 hours.[1036]

Proposed paragraph (c) of new Rule 17g-8 would implement Section 15E(h)(4)(A)(ii) of the Exchange Act by requiring the NRSRO to establish, maintain, and enforce certain policies and procedures pursuant to Section 15E(h)(4)(A) of the Exchange Act.[1037] The Commission preliminarily believes that the hour burdens resulting from this proposal would be closer to the one-time hour burden estimate for Rule 17g-4 because these policies and procedures would

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1032 10 NRSROs x 50 hours = 500 hours.

1033 See Pub. L. No. 111-203 § 938(a) and proposed paragraph (b) of new Rule 17g-8; see also Section II.J.1 of this release for a more detailed discussion of this proposal.

1034 See Pub. L. No. 111-203 §§ 938(a)(1)-(3).

1035 10 NRSROs x 200 hours = 2,000 hours.

1036 10 NRSROs x 50 hours = 500 hours.

1037 See 15 U.S.C. 78o-7(h)(4)(A)(ii) and proposed new paragraph (c) of Rule 17g-8; see also Section II.C.1 of this release for a more detailed discussion of this proposal.

supplement policies and procedures that are required under a separate self-executing statutory provision. However, the Commission also believes there would be new policies and procedures and, therefore, as with the proposed requirements in paragraphs (a) and (b) of new Rule 17g-8, the NRSRO would need to establish new policies and procedures. For these reasons, the Commission preliminarily estimates an NRSRO would spend an average of approximately 100 hours establishing the policies and procedures, resulting in an industry-wide one-time hour burden of approximately 1,000 hours.[1038] In addition, the Commission preliminarily estimates an NRSRO would spend an average of approximately 25 hours per year reviewing the policies and procedures and updating them (if necessary), resulting in an average industry-wide annual hour burden of approximately 250 hours.[1039]

For the foregoing reasons, the Commission estimates that the total industry-wide one-time hour burden to the NRSROs resulting from the proposed amendments to Rule 17g-8 would be approximately 5,000 hours[1040] and the total industry-wide annual hour burden would be approximately 1,250 hours.[1041]

### 7. Proposed New Rule 17g-9

The Commission is proposing new Rule 17g-9.[1042] This rule would implement Section 936 of the Dodd-Frank Act by requiring an NRSRO to establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to

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1038 10 NRSROs x 100 hours = 1,000 hours.

1039 10 NRSROs x 25 hours = 250 hours.

1040 2,000 hours + 2,000 + 1,000 hours = 5,000 hours.

1041 500 hours + 500 hours + 250 hours = 1,250 hours.

1042 Proposed new Rule 17g-9 would be codified at 17 CFR 240.17g-9, if adopted.

determine credit ratings.[1043] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for NRSROs.

In this regard, the Commission preliminarily believes that several of the NRSROs already have implemented standards of training, experience, and competence for the individuals they employ to determine credit ratings. For example, Section 1.4 of the Code of Conduct Fundamentals for Credit Rating Agencies of the International Organization of Securities Commissions ("IOSCO Code") provides that credit rating agencies "should use people who, individually or collectively (particularly where rating committees are used) have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied."[1044] A number of NRSROs disclose that they have implemented the IOSCO Code.[1045] In addition, some NRSROs disclose in the Exhibits to their Form NRSROs that they have standards of training, experience, competence, continuing education, and testing programs for their credit analysts.[1046]

As noted above, the size and complexity of the NRSROs varies greatly. The magnitude of this variance is reflected in the number of credit analysts and credit analyst supervisors each NRSRO employs (hereinafter collectively referred to as "credit analysts") as shown in Figure 3

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1043 See Pub. L. No. 111-203 § 936 and proposed new Rule 17g-9; see also Section II.I.1 of this release for a more detailed discussion of this proposal.

1044 Code of Conduct Fundamentals for Credit Rating Agencies, Technical Committee of IOSCO (May 2008).

1045 The following NRSROs, for example, reported in Exhibit 5 to Form NRSRO that they comply with the IOSCO Code: A.M. Best Company, Inc., DBRS Ltd., Kroll Bond Rating Agency, Inc., Moody's Investors Service, Inc., Rating and Investment Information, Inc., Realpoint LLC, and Standard & Poor's Ratings Services.

1046 For example, Fitch, Inc., Moody's Investors Service, Inc., and Standard & Poor's Ratings Services reported in Exhibit 8 to Form NRSRO that they had standards of experience and competence for their credit analysts, and Moody's Investors Service, Inc. reported in Exhibit 5 to Form NRSRO that its analysts were required to complete 20 hours of coursework annually.

above.[1047] For example, three NRSROs employed over 1,000 credit analysts as of calendar year-end 2009 and three NRSROs employed fewer than 30 credit analysts.

The Commission preliminarily estimates that the degree of the one-time and annual hour burdens resulting from proposed new Rule 17g-9 would depend on the number of credit analysts an NRSRO employs as well as the range and complexity of the obligors, securities, and money market instruments it rates. Consequently, the one-time and annual hour burdens per NRSRO would vary widely.

In order to account for this variance, the Commission preliminarily believes that the one-time and annual hour burden estimates should be based on the number of credit rating analysts employed by the NRSROs. Based on the 2009 annual certifications, the Commission estimates that the NRSROs currently employ approximately 3,520 credit analysts.[1048] In addition, as noted above, the Commission preliminarily believes some of the NRSROs have established standards of training, experience, and competence for their credit analysts. Consequently, for purposes of this estimate, the Commission preliminarily believes these firms would be required to augment or modify existing standards to comply with the proposed rule as opposed to developing a set of completely new standards. For these reasons, the Commission preliminarily estimates that the one-time burden to establish the standards required pursuant to proposed new Rule 17g-9 would

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[1047] These figures are based on the annual certifications on Form NRSRO submitted to the Commission and publicly disclosed by the NRSROs for the calendar year-end 2009. See Annual Report on Nationally Recognized Statistical Rating Organizations, Commission (Jan. 2011), p. 5.

[1048] NRSROs reported that they have a total of 3,520 credit analysts and 820 credit analyst supervisors. See Figure 3. As discussed above in Section II.M.4.b of this release, some NRSROs included credit analyst supervisors in the number of credit analysts they reported; whereas others may not have included the supervisors. Based on staff experience, the Commission preliminarily believes that the majority of NRSROs included credit analyst supervisors in the number of reported credit analysts. Consequently, for the purposes of the PRA, the Commission is using a total of 3,520 credit analysts across the 10 NRSROs.

be approximately 5 hours per credit analyst, resulting in an industry-wide one-time hour burden of approximately 17,600 hours.[1049] In addition, the Commission preliminarily allocates 75% of these burden hours (13,200 hours) to internal burden and the remaining 25% (4,400 hours) to external burden to hire outside professionals to assist in setting up training programs.[1050] The Commission preliminarily estimates $400 per hour for external costs for retaining outside consultants, resulting in an industry-wide cost of approximately $1,760,000.[1051] Although larger NRSROs may realize economies of scale, the Commission preliminarily estimates that the industry-wide annual hour burden of 17,600 hours, including the external burden costs, would be allocated to each NRSRO based on the number of credit analysts the firm employs.[1052]

The Commission believes that the annual hour burden to comply with proposed new Rule 17g-9 would be less than the one-time hour burden since NRSROs would have established the standards of training, experience, and competence for the individuals they employ to determine credit ratings. The annual hour burden would arise from reviewing and updating the standards. Consequently, the Commission preliminarily estimates that the annual industry-wide hour burden to update the standards would be approximately 1 hour per credit analyst employed, resulting in an industry-wide annual hour burden of approximately 3,520 hours across all NRSROs.[1053] In addition, the Commission preliminarily allocates 75% of these burden hours

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1049 3,520 credit analysts x 5 hours = 17,600 hours.

1050 17,600 hours x 0.75 = 13,200 hours; 17,600 hours x 0.25 = 4,400 hours.

1051 4,400 hours x $400 = $1,760,000. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

1052 See Figure 3.

1053 3,520 credit analysts x 1 hour = 3,520 hours.

(2,640 hours) to internal burden and the remaining 25% (880 hours) to external burden to hire outside professionals to assist in reviewing and updating training programs.[1054] The Commission preliminarily estimates $400 per hour for external costs for retaining outside consultants, resulting in an industry-wide cost of $352,000.[1055] Finally, although larger NRSROs may realize economies of scale, the Commission estimates that the industry-wide annual hour burden of 3,520 hours, including the external costs, would be allocated to each NRSRO based on the number of credit analysts the firm employs.[1056]

For the foregoing reasons, the Commission estimates that proposed new Rule 17g-9 would result in a total industry-wide one-time hour burden of approximately 17,600 hours,[1057] a total industry-wide one-time cost of approximately $1,760,000, a total industry-wide annual hour burden of approximately 3,520 hours, and a total industry-wide annual external cost of approximately $352,000.

### 8. Proposed New Rule 17g-10 and Form ABS Due Diligence-15E

The Commission is proposing new Rule 17g-10 and new Form ABS Due Diligence-15E.[1058] Proposed new Rule 17g-10 would implement rulemaking mandated in Sections 15E(s)(4)(B) and (C) of the Exchange Act by requiring that the written certification a provider of

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1054 3,520 hours x 0.75 = 2,640 hours; 3,520 hours x 0.25 = 880 hours.

1055 880 hours x $400 = $352,000. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

1056 See Figure 3.

1057 2,000 hours + 2,000 + 1,000 hours = 5,000 hours.

1058 Proposed new Rule 17g-10 would be codified at 17 CFR 240.17g-10 and proposed new Form ABS Due Diligence-15E would be identified at 17 CFR 249b.400.

third-party due diligence services must provide to an NRSRO be made on Form ABS Due Diligence-15E.[1059] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for providers of third-party due diligence services.

In terms of one-time hour burdens, the Commission preliminarily estimates that providers of third-party due diligence services would need to develop processes and protocols to provide the required information in new Form ABS Due Diligence-15E and submit the certifications to NRSROs. The Commission preliminarily estimates that providers of third-party due diligence services would spend an average of approximately 300 hours per firm developing these processes and protocols, resulting in a one-time industry-wide hour burden of 3,000 hours.[1060] In addition, the Commission preliminarily allocates 75% of these burden hours (2,250 hours) to internal burden and the remaining 25% (750 hours) to external burden to hire outside attorneys to provide legal advice on the requirements of new Rule 17g-10 and Form ABS Due Diligence-15E.[1061] The Commission preliminarily estimates $400 per hour for external costs for retaining outside consultants, resulting in an industry-wide one-time cost of $300,000.[1062]

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1059 See 15 U.S.C. 78o-7(s)(4)(B) and (C), proposed new Rule 17g-10, and proposed new Form ABS Due Diligence-15E; see also Sections II.H of this release for a more detailed discussion of this proposal.

1060 10 Providers of third-party due diligence services x 300 hours = 3,000 hours. This estimate is based on the Commission's estimate for the amount of time it would take a securitizer to set-up a system to make the disclosures required by Form ABS-15G. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011). The Commission, however, has reduced the hour estimate of 850 hours used for Form ABS-15G by approximately two-thirds because information required to provided in proposed new Form ABS Due Diligence-15E is substantially less detailed and complex than the information required in Form ABS-15G.

1061 3,000 hours x 0.75 = 2,250 hours; 3,000 hours x 0.25 = 750 hours.

1062 750 hours x $400 = $300,000. See Disclosure for Asset-Backed Securities Required by

With respect to the annual burden, the Commission preliminarily believes that the estimate should be based on the number of issuances per year of Exchange Act-ABS because the requirement to produce the certification and provide it to NRSROs would be triggered when an issuer, underwriter, or NRSRO hires a provider of third-party due diligence services for transactions.[1063] In the PRA for the adoption of Rule 17g-7, the Commission estimated, on average, there would be approximately 2,067 Exchange Act-ABS offerings per year.[1064] In addition, the Commission preliminarily estimates that a provider of third-party due diligence services would spend approximately 30 minutes completing and submitting Form ABS Due Diligence-15E. The Commission bases this preliminary estimate on the fact that the first three Items in the form require basic information and the fourth Item (the due diligence performed) and the fifth Item (the findings and conclusions of the review) could be drawn directly from the due diligence reports the Commission expects that providers of third-party due diligence services generate with respect to their performance of due diligence services. Therefore, the Commission

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Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

1063 See 15 U.S.C. 78o-7(s)(4)(B) and (C), and proposed new Rule 17g-10.

1064 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4508 (Jan. 26, 2011). The Commission notes that issuers, underwriters, and NRSROs may not use providers of third-party due diligence services with respect to every issuance of Exchange Act-ABS. For example, as discussed in Section II.H of this release, the Commission preliminarily believes that providers of third-party due diligence services are used primarily for RMBS transactions. However, the Commission's estimate uses the total number of estimated Exchange Act-ABS offerings (as opposed to a lesser amount based on an estimate of RMBS offerings) because the use of providers of third-party due diligence services may migrate to other types of Exchange Act-ABS. This also makes the Commission's estimates more conservative.

preliminarily estimates that the industry-wide annual hour burden resulting from proposed new Rule 17g-10 and Form ABS Due Diligence-15E would be approximately 1,034 hours.[1065]

For the foregoing reasons, the Commission estimates proposed new Rule 17g-8 would result in a total industry-wide one-time burden of approximately 3,000 hours, a total industry-wide one-time cost of approximately $300,000, and a total industry-wide annual hour burden of approximately 1,034 hours.

### 9. Rule 15Ga-2 and Form ABS-15G

The Commission is proposing new Rule 15Ga-2 and amendments to Form ABS-15G.[1066] The new rule and amended form would implement Section 15E(s)(4)(A) of the Exchange Act.[1067] As discussed below, the Commission preliminarily estimates that these proposals would result in additional one-time and annual hour burdens for issuers and underwriters of the Exchange Act-ABS.

Proposed new Rule 15Ga-2 would require an issuer or underwriter of any Exchange Act-ABS that is to be rated by an NRSRO to furnish a Form ABS-15G on the EDGAR system containing the findings and conclusions of any third-party "due diligence report" obtained by the issuer or underwriter. Under the proposal, the disclosure would be furnished using Form ABS-15G for both registered and unregistered offerings of Exchange Act-ABS. In addition, under the Commission's proposal, an issuer or underwriter would not need to furnish Form ABS-15G if the issuer or underwriter obtains a representation from each NRSRO engaged to produce a credit rating for the Exchange Act-ABS that can be reasonably relied on that the NRSRO will publicly

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1065 2,067 Exchange Act-ABS offerings x 30 minutes = 1,034 hours.

1066 See proposed new Rule 15Ga-2 and proposed amendments to Form ABS-15G.

1067 See 15 U.S.C. 78o-7(s)(4)(A); see also Section II.H.1 of this release for a more detailed discussion of this proposal.

disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7.

The Commission preliminarily believes that this proposal would result in a one-time hour burden to issuers and underwriters in offerings of registered and unregistered Exchange Act-ABS in connection with developing processes and protocols to provide the required information to comply with new Rule 15Ga-2, including modifying their existing Form ABS-15G processes and protocols to accommodate the requirements of Rule 15Ga-2. In the adopting release for Form ABS-15G, the Commission estimated that 270 unique securitizers would be required to file the form.[1068] The Commission preliminarily estimates that each securitizer would require approximately 100 hours to develop processes and protocols to comply with new Rule 15Ga-2 and to modify their existing Form ABS-15G processes and protocols to provide for the disclosure of the information required pursuant to Rule 15Ga-2, resulting in an industry-wide total of 27,000 hours.[1069] The Commission believes that this work would be done internally by issuers and underwriters.

The PRA burden assigned to Form ABS-15G reflects the cost of preparing and furnishing the form on EDGAR. As noted above, the proposed amendment to Form ABS-15G would

1068 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4506 (Jan. 26, 2011).

1069 270 unique securitizers x 100 hours = 27,000 hours. This estimate is based on the Commission's estimate for the amount of time it would take a securitizer to set up a system to make the disclosures required by Form ABS-15G as originally adopted by the Commission. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011). The Commission, however, believes that the hour burden for amending existing Form ABS-15G processes and protocols will be significantly lower than the estimate of 850 hours used to initially develop those processes and protocols.

require that it be furnished by issuers and underwriters in offerings of registered and unregistered Exchange Act-ABS. Consequently, the Commission preliminarily believes that the estimate of the annual hour burden for furnishing Form ABS-15G should be based on an estimate of the number of Exchange Act-ABS offerings per year. As noted above, in the PRA for the adoption of Rule 17g-7, the Commission estimated, on average, there would be approximately 2,067 Exchange Act-ABS offerings per year.[1070] In addition, the Commission preliminarily estimates that an issuer or underwriter would spend approximately one hour completing and submitting Form ABS-15G for purposes of meeting the requirement in Rule 15Ga-2. The Commission bases this preliminary estimate on the fact that Form ABS-15G would elicit much less information when used solely for the purpose of complying with proposed new Rule 15Ga-2. In addition, the information required in the form could be drawn directly from the due diligence reports the Commission expects providers of third-party due diligence services generate with respect to their performance of due diligence services. Therefore, the Commission preliminarily estimates that the industry-wide annual hour burden resulting from proposed new Rule 15Ga-2 and the amendments to Form ABS-15G would be approximately 2,067 hours.[1071] In addition, the Commission preliminarily believes that this work would be done internally by issuers and underwriters of Exchange Act-ABS.

1070 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4508 (Jan. 26, 2011). As noted above, issuers, underwriters, and NRSROs may not use providers of third-party due diligence services with respect to every issuance of Exchange Act-ABS. For example, as discussed in Section II.H of this release, the Commission preliminarily believes that providers of third-party due diligence services are used primarily for RMBS transactions. However, the Commission's estimate uses the total number of estimated Exchange Act-ABS offerings (as opposed to a lesser amount based on an estimate of RMBS offerings) because the use of providers of third-party due diligence services may migrate to other types of Exchange Act-ABS. This also makes the Commission's estimates more conservative.

1071 2,067 Exchange Act-ABS transactions x 1 hour = 2,067 hours.

To avoid duplicative disclosure, however, the Commission notes that an issuer or underwriter would not need to furnish Form ABS-15G if the issuer or underwriter obtains a representation from each NRSRO engaged to produce a credit rating for the Exchange Act-ABS that can be reasonably relied on that the NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7. The Commission anticipates that issuers and underwriters subject to this proposed requirement likely will seek to obtain such representations from the NRSROs engaged to produce credit ratings for Exchange Act-ABS. Consequently, the PRA burden for issuers and underwriters may be reduced substantially. However, to be conservative, the Commission preliminarily allocates the PRA burden for complying with proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G to the issuers and underwriters.

In addition, the Commission also is proposing to permit issuers of municipal Exchange Act-ABS, or underwriters in such offerings, to provide the information required by Form ABS-15G on EMMA. The Commission believes this would limit the PRA burden on issuers and underwriters of municipal Exchange Act-ABS subject to the proposed rule, as well as provide the disclosure for investors in the same location as other disclosures regarding municipal Exchange Act-ABS.

For the foregoing reasons, the Commission preliminarily estimates that proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G would result in a total industry-wide one-time hour burden of approximately 27,000 hours and a total industry-wide annual hour burden of approximately 2,067 hours.

### 10. Proposed Amendments to Regulation S-T

The Commission is proposing that certain Form NRSRO submissions and all Rule 17g-3 annual report submissions be submitted to the Commission using the EDGAR system. In order to implement this requirement, the Commission is proposing amendments to Rule 101 of Regulation S-T to require the electronic submission using the EDGAR system of Form NRSRO pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports pursuant to Rule 17g-3.[1072] The Commission also is proposing to amend Rule 201 of Regulation S-T, which governs temporary hardship exemptions from electronic filing, to make this exemption unavailable for NRSRO submissions.[1073]

The Commission is proposing new Rule 15Ga-2, which would require an issuer or underwriter of any Exchange Act-ABS that is to be rated by an NRSRO to furnish a Form ABS-15G on the EDGAR system containing the findings and conclusions of any third-party "due diligence report" obtained by the issuer or underwriter.[1074]

OMB requires the Commission to assign a burden of one hour to Regulation S-T and to indicate that the Regulation has one respondent so that the automated OMB system will be able to handle approval of the Regulation. OMB has already approved a burden of one hour for one respondent to the Regulation.

### 11. Form ID

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[1072] See proposed amendment of Rule 101 of Regulation S-T (17 CFR 231.101); see also Section II.L of this release for a more detailed discussion of this proposal.

[1073] See proposed amendment of Rule 201 of Regulation S-T (17 CFR 231.201); see also Section II.L of this release for a more detailed discussion of this proposal.

[1074] See proposed new Rule 15Ga-2 and proposed amendments to Form ABS-15G; see also Section II.H.1 of this release for a more detailed discussion of this proposal.

The Commission expects that NRSROs would need to file a Form ID with the Commission in order to gain access to the EDGAR system. Form ID is used to request the assignment of access codes to make submissions on EDGAR. The current OMB approved hour burden for Form ID is 15 minutes per respondent.[1075] Thus, the Commission estimates that the total one-time hour burden resulting from filing Form ID would be approximately 2.5 hours.[1076]

The Commission preliminarily believes that the issuers and underwriters of Exchange Act-ABS that would need to furnish Form ABS-15G to the Commission through the EDGAR system pursuant to proposed new Rule 15Ga-2 already have access to the EDGAR system because, for example, they need such access for the purpose of Rule 15Ga-1.

### 12. Total Paperwork Burdens

Based on the foregoing, the Commission estimates that the total recordkeeping burden for NRSRO respondents resulting from the proposed rule amendments and proposed new rules would be approximately 77,150 industry-wide one-time hours, $7,160,000 industry-wide external one-time costs, 741,140 industry-wide annual hours, and $552,000 industry-wide external annual costs.

Based on the foregoing, the Commission estimates that the total recordkeeping burden for respondents that are providers of third-party due diligence services resulting from the rule amendments and proposed new rules would be approximately 3,000 industry-wide one-time hours, $300,000 industry-wide external one-time costs, and 1,034 industry-wide annual hours.

Based on the foregoing, the Commission estimates that the total recordkeeping burden for issuer and underwriter respondents resulting from the rule amendments and proposed new rules

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1075 See Form ID (OMB Number 3235-0328).

1076 10 NRSROs x 15 minutes = 150 minutes; 150 minutes/60 minutes = 2.5 hours.

would be approximately 27,000 industry-wide one-time hours and 2,067 industry-wide annual hours.

### E. COLLECTION OF INFORMATION IS MANDATORY

The collections of information pursuant to the proposed amendments and new rules are mandatory, as applicable, for NRSROs, providers of third-party due diligence services, and issuers and underwriters.

### F. CONFIDENTIALITY

Other than information for which an NRSRO, provider of third-party due diligence services, or issuer or underwriter requests confidential treatment, or as may otherwise be kept confidential by the Commission, and which may be withheld from the public in accordance with the provisions of FOIA, the collection of information requirements resulting from the proposed amendments and new rules would not be confidential and would be publicly available.[1077]

### G. RETENTION PERIOD OF RECORDKEEPING REQUIREMENTS

All records an NRSRO is required to retain under Rule 17g-3 (including records that would need to be made or received by an NRSRO under the proposed amendments and new rules) must be retained for three years after the record is made or retained.[1078]

The Dodd-Frank Act did not establish record retention requirements for providers of third-party due diligence services.

The records issuers and underwriters are required to make and furnish to the Commission pursuant to the requirements in proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G would be mandatory. Responses to the information collections will not be kept confidential and there is no mandatory retention period for the collections of information.

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[1077] See 15 U.S.C. 552 et seq.

[1078] See 17 CFR 240.17g-2(a), (b), and (c).

## H. REQUEST FOR COMMENT

Pursuant to 44 U.S.C. 3505(c)(2)(B), the Commission solicits comment to:

1. Evaluate whether the proposed collection of information requirements are necessary for the performance of the functions of the Commission, including whether the information shall have practical utility;
2. Evaluate the accuracy of the Commission's estimates of the burden of the proposed collection of information requirements;
3. Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
4. Minimize the burden of the collection of information requirements on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, OMB, Room 3208, New Executive Office Building, Washington, DC 20503; and (2) Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090 with reference to File No. S7-[_____]. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collection of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-[____], and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, Station Place, 100 F Street, NE, Washington, DC 20549 0213.

## V. ECONOMIC ANALYSIS

The Commission is sensitive to the costs imposed by its rules. To the extent possible, the discussion below focuses on the benefits and costs of the decisions made by the Commission to fulfill the mandates of the Dodd-Frank Act within its permitted discretion, rather than the benefits and costs of the mandates of the Dodd-Frank Act itself. However, as discussed below, to the extent that the Commission exercises discretion in implementing the provisions of the Dodd-Frank Act, the benefits and costs arising from the Commission's exercise of its discretion and the benefits and costs arising directly from the requirements of the Dodd-Frank Act are not entirely separable. Accordingly, where the Commission believes that it has exercised some discretion in implementing the Dodd-Frank Act, hour burden estimates and dollar cost estimates in the above PRA analysis are included in full below, even where a portion – in most cases, the significantly greater portion – of the anticipated costs are attributable to the rulemaking mandates of the Dodd-Frank Act and not the exercise of the Commission's discretion in how to implement those requirements.[1079] Where the Commission believes, however, that it has not exercised discretion in implementing the rulemaking mandates of the Dodd-Frank Act and that any anticipated benefits and costs are <u>entirely</u> attributable to those mandates, those anticipated benefits and costs are not addressed in the discussion below. Finally, as used below, the term "incremental costs" refers to costs attributable to the exercise of the Commission's rulemaking

[1079] For purposes of this economic analysis, the Commission's salary figures are from SIFMA's Management & Professional Earnings in the Securities Industry 2010, 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.

discretion that are in addition to costs attributable to the rulemaking mandates of the Dodd-Frank Act.

In addition, the Commission notes that Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[1080] Furthermore, Section 23(a)(2) of the Exchange Act requires the Commission, when issuing rules under the Exchange Act, to consider the impact such rules would have on competition.[1081] 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.[1082] The Commission's analysis under these requirements as applied to the proposed amendments to existing rules and proposed new rules is included below in the discussions of the benefits and the costs of the proposals where appropriate. In this regard, the Commission's analysis focuses on the discretionary component of the Commission's proposals and the incremental costs resulting from that discretion.

Unless otherwise noted, the total one-time and annual cost estimates per NRSRO for PRA purposes as used in this section are averages across all types of NRSROs that would be subject to the proposed amendments and new rules. The NRSROs vary, in terms of size and complexity, from small entities that employ less than 20 credit analysts to complex global organizations that employ over a thousand credit analysts.[1083] Given the variance in size

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1080 See 15 U.S.C. 78c(f).

1081 See 15 U.S.C. 78w(a)(2).

1082 See id.

1083 See, e.g., Annual Report on Nationally Recognized Statistical Rating Organizations.

between the largest NRSROs and the smallest NRSROs, the cost estimates, as averages across all NRSROs, are skewed higher because the largest firms currently dominate in terms of size and the volume of credit rating activities.[1084]

The Commission's estimates of the benefits and costs of the proposals, as well as the anticipated effects on efficiency, competition and capital formation, are described below. The Commission recognizes that there may be benefits and costs resulting from the proposals that are not required to be described or otherwise identified below. The Commission generally requests that commenters identify and describe any such benefits and costs.

### A. INTERNAL CONTROL STRUCTURE

Section 932(a)(2)(B) of the Dodd-Frank Act added paragraph (3) to Section 15E(c) of the Exchange Act.[1085] Section 15E(c)(3)(A) requires an NRSRO to "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe by rule."[1086] Section 15E(c)(3)(B) of the Exchange Act provides that the Commission shall prescribe rules requiring an NRSRO to submit an annual internal controls report to the Commission, which shall contain: (1) a description of the responsibility of management in establishing and maintaining an effective

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Commission (January 2011), pp. 4-9.

1084 As discussed above in Section IV.D of this release, based on data collected from the NRSROs in their Form NRSROs and Rule 17g-3 annual reports, the Commission has calculated an HHI number using the number credit ratings outstanding per NRSRO and that number is 3,495, which is equivalent to there being approximately 2.86 equally sized firms. The HHI using earnings reported by NRSROs in the Rule 17g-3 annual reports is 3,926, which the equivalent of 2.55 equally sized firms.

1085 See Pub. L. No. 111-203 § 932(a)(2)(B) and 15 U.S.C. 78o-7(c)(3)(A); see also Section II.A.1 of this release for a more detailed discussion of this provision.

1086 Id.

internal control structure; (2) an assessment of the effectiveness of the internal control structure; and (3) the attestation of the CEO or equivalent individual.[1087] The Commission proposes to implement this rulemaking by: (1) adding a new paragraph (b)(12) to Rule 17g-2;[1088] and (2) amending paragraphs (a) and (b) of Rule 17g-3.[1089]

Proposed new paragraph (b)(12) of Rule 17g-2 would identify the internal control structure an NRSRO, among other things, must document pursuant to Section 15E(c)(3)(A) of the Exchange Act as a record that must be retained.[1090] As a result, the various retention and production requirements of paragraphs (c), (d), (e), and (f) of Rule 17g-2 in its current form would apply to the documented internal control structure.[1091]

Proposed new paragraph (a)(7) of Rule 17g-3 would require an NRSRO to include with the other reports required under that rule a report regarding the NRSRO's internal control structure established pursuant to Section 15E(c)(3)(A) of the Exchange Act.[1092] The proposed amendment would mirror the text of Section 15E(c)(3)(B) of the Exchange Act by requiring that the report contain: (1) a description of the responsibility of management in establishing and maintaining an effective internal control structure; and (2) an assessment by management of the effectiveness of the internal control structure.[1093] The Commission's proposed amendment to

1087 See 15 U.S.C. 78o-7(c)(3)(B)(i)-(iii).

1088 See proposed new paragraph (b)(12) to Rule 17g-2; see also Section II.A.2 of this release for a more detailed discussion of this proposal.

1089 See proposed new paragraphs (a)(7) and of Rule 17g-3; see also Section II.A.3 of this release for a for a more detailed discussion of these proposals.

1090 See proposed new paragraph (b)(12) of Rule 17g-2.

1091 See 17 CFR 240.17g-2(c), (d), (e) and (f).

1092 See proposed new paragraph (a)(7) of Rule 17g-3.

1093 Compare 15 U.S.C. 78o-7(c)(3)(B)(i) and (ii) and proposed new paragraphs (a)(7)(i) and (ii) of Rule 17g-3.

paragraph (b) of Rule 17g-3 would require that the NRSRO's CEO, or, if the firm does not have a CEO, an individual performing similar functions, provide a signed statement that would need to be attached to the report.[1094] The CEO or other individual would need to state, among other things, that the report fairly presents, in all material respects, a description of the responsibility of management in establishing and maintaining an effective internal control structure and an assessment of the effectiveness of the internal control structure.

**1. Benefits**

Section 15E(c)(3)(A) of the Exchange Act requires an NRSRO to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.[1095] The Commission proposes to further implement this provision by applying the record retention and production requirements of Rule 17g-2 to the documented internal control structure by adding new paragraph (b)(12).[1096] Recordkeeping rules such as Rule 17g-2 have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws.[1097] Rule 17g–2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is complying with applicable securities laws, including the provisions of Section 15E of the Exchange Act and the rules thereunder.[1098] The proposed amendment to Rule 17g-2 is designed to assist the Commission in monitoring an

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1094 See proposed amendments to paragraph (b) of Rule 17g-3.

1095 See 15 U.S.C. 78o-7(c)(3)(A).

1096 See 17 CFR 240.17g-2(c), (d), (e) and (f).

1097 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33582 (June 18, 2007).

1098 Id.

NRSRO's compliance with the requirement in Section 15E(c)(3)(A) of the Exchange Act to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.

The Commission preliminarily believes that implementing the internal control structure reporting requirement through an amendment to Rule 17g-3 would facilitate the Commission's oversight of NRSROs. First, it would assist the Commission in monitoring an NRSRO's compliance with the requirement in Section 15E(c)(3)(A) of the Exchange Act to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings. Second, it would specify the format, manner, and timeframe in which the report must be submitted to the Commission, thereby facilitating the Commission's processing of the report. Furthermore, the Commission preliminarily believes that proposed amendments to Rules 17g-2 and 17g-3 would provide an efficient process for NRSROs by allowing them to file the internal control report with the other annual reports required under Rule 17g-3.

**2. Costs**

The Commission preliminarily estimates that, although the costs resulting from the proposed amendment to Rule 17g-2, discussed below, would largely be attributable to the Commission's discretionary rulemaking, those incremental costs would be minimal. An NRSRO already should have recordkeeping and control systems in place to comply with the existing requirements in Rule 17g-2 to make and retain or to retain documents listed in the rule.

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion with respect to the amendments to Rule 17g-3 would also impose minimal incremental costs. The Commission preliminarily estimates that the costs resulting from the proposed amendments to Rule 17g-3 would largely be attributable to the rulemaking mandated by the Dodd-Frank Act.[1099]

An NRSRO already should have control systems in place to comply with the existing requirements of Rule 17g-3. Consequently, the Commission preliminarily estimates that the internal hour burden associated with the first filing of the internal control report would not be materially different than the hour burden associated with filing subsequent reports (though the time spent on subsequent reports may decrease incrementally over time as the NRSRO gains experience with the requirement). The Commission, however, preliminarily believes that an NRSRO likely would engage outside counsel to analyze the requirements for the report and assist in drafting and reviewing the first report, given that it must be signed by the NRSRO's CEO or an individual performing a similar function. The time an outside attorney would spend on this work would depend on the size and complexity of the NRSRO.

In addition, as discussed above in Section IV.D.4 of this release with respect to the PRA, the Commission preliminarily believes an NRSRO likely would continue to engage outside counsel to assist in the process of preparing the report on an annual basis and that the time an outside attorney would spend on this work would depend on the size and complexity of the NRSRO but in all cases be less than time spent on the first report.

In sum, limiting the analysis to the elements of the proposals over which the Commission exercised discretion, the Commission acknowledges that the proposals would entail some compliance burdens for NRSROs. Some of the compliance effects are estimated for the industry in Sections Section IV.D.3and Section IV.D.4 as $600,000 for the use of outside counsel and

1099 Compare 15 U.S.C. 78o-7(c)(3)(B)(i) and (ii) with proposed new paragraphs (a)(7)(i), (a)(7)(ii), and (b)(2) of Rule 17g-3.

1,550 internal burden hours for creating and retaining documents and complying with management's assessment of the internal control structure. However, the Commission preliminarily believes these compliance effects would result largely from the rulemaking mandated by the Dodd-Frank Act rather than the Commission's exercise of discretion.

The Commission preliminarily believes that the incremental cost resulting from the proposed amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new paragraph (b)(12) of Rule 17g-2 and proposed new paragraphs (a)(7) and (b)(2) of Rule 17g-3.

## B. CONFLICTS OF INTEREST RELATING TO SALES AND MARKETING

Section 932(a)(4) of the Dodd-Frank Act added new paragraph (3) to Section 15E(h) of the Exchange Act.[1100] Section 15E(h)(3)(A) of the Exchange Act provides that the Commission shall issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of credit ratings by the NRSRO.[1101] The Commission is proposing to implement this provision by identifying a new conflict of interest in paragraph (c) of Rule 17g-5.[1102] The existing requirements in paragraph (c) prohibit a person within an NRSRO (which includes the NRSRO)[1103] from having any of the conflicts of interest identified in the paragraph

1100 Pub. L. No. 111-203 § 932(a)(4) and 15 U.S.C. 78o-7(h)(3).

1101 15 U.S.C. 78o-7(h)(3)(A).

1102 See proposed new paragraph (c)(8) of Rule 17g-5; see also Section II.B.1 of this release for a more detailed discussion of this proposal.

1103 See paragraph (d) of Rule 17g-5 defining "person within an NRSRO" for purposes of the rule. 17 CFR 240.17g-5(d).

under all circumstances.[1104] Proposed new paragraph (c)(8) of Rule 17g-5 would identify a new absolute prohibition: an NRSRO issuing or maintaining a credit rating where a person within the NRSRO who participates in the sales or marketing of a product or service of the NRSRO or a product or service of a person associated with the NRSRO also participates in determining or monitoring the credit rating or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.[1105]

Section 15E(h)(3)(B) of the Exchange Act provides that the Commission's rules must contain two additional provisions.[1106] First, Section 15E(h)(3)(B)(i) requires that the Commission's rules shall provide for exceptions for small NRSROs with respect to which the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate.[1107] To implement this provision, the Commission is proposing to amend Rule 17g-5 by adding a new paragraph (f).[1108] Proposed paragraph (f) would provide a mechanism for a small NRSRO to apply in writing for an exemption from the absolute prohibition proposed in new paragraph (c)(8). In particular, proposed new paragraph (f) of Rule 17g-5 would provide that upon written application by an NRSRO, the Commission may exempt, either conditionally or unconditionally or on specified terms and conditions, such NRSRO from the provisions of paragraph (c)(8) of Rule 17g-5 if the Commission finds that due to the small size of the NRSRO it is not appropriate to require the separation within the NRSRO of the

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1104 See 17 CFR 240.17g-5(c)(1)-(7).

1105 See proposed new paragraph (c)(8) of Rule 17g-5.

1106 15 U.S.C. 78o-7(h)(3)(B)(i) and (ii).

1107 15 U.S.C. 78o-7(h)(3)(B)(i).

1108 See proposed new paragraph (f) of Rule 17g-5; see also Section II.B.2 of this release for a more detailed discussion of this proposal.

production of credit ratings from sales and marketing activities and such exemption is in the public interest.[1109]

Second, Section 15E(h)(3)(B)(ii) requires that the Commission's rules shall provide for the suspension or revocation of the registration of an NRSRO if the Commission finds, on the record, after notice and opportunity for a hearing, that the NRSRO has committed a violation of a rule issued under Section 15E(h) of the Exchange Act; and (2) the violation affected a rating.[1110] The Commission proposes to implement this provision by adding new paragraph (g) of Rule 17g-5.[1111] This paragraph would provide that in a proceeding pursuant to Section 15E(d) or Section 21C of the Exchange Act, the Commission shall suspend or revoke the registration of an NRSRO if the Commission finds in such proceeding that the NRSRO has violated a rule issued under Section 15E(h) of the Exchange Act, the violation affected a rating, and that suspension or revocation is necessary for the protection of investors and in the public interest.

**1. Benefits**

The Commission preliminarily believes that the proposed new absolute prohibition in proposed paragraph (c)(8) of Rule 17g-5 would provide benefits to investors by mitigating the potential that undue influences based on sales and marketing considerations could impact the objectivity of the NRSRO's credit rating process.[1112] As discussed above in Section II.B.1 of

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1109 See proposed new paragraph (f) of Rule 17g-5.

1110 15 U.S.C. 78o-7(h)(3)(B)(ii).

1111 See proposed new paragraph (g) of Rule 17g-5; see also Section II.B.3 of this release for a more detailed discussion of this proposal.

1112 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33598-33599, 33613 (June 18, 2007) (discussing objectives and benefits of paragraph (c) of Rule 17g-5 when it was adopted); see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6465-6469, 6474-6475 (February 9, 2009) (discussing objectives and benefits of paragraph (c) of Rule 17g-5 when it was amended).

this release, Commission staff found as part of its 2007-2008 examination of the activities of the three largest NRSROs in rating asset-backed securities linked to subprime mortgages that it appeared that marketing personnel discussed with other employees, including those responsible for credit rating criteria development, business concerns they had related to those criteria.[1113] The rule proposal would be designed to insulate individuals within the NRSRO responsible for determining credit ratings from such pressures. In addition, the bright line on prohibited behavior is likely to allow the company to effectively comply with the proposed rules. The Commission believes that this could benefit investors by increasing the integrity of credit ratings and the procedures and methodologies used to determine credit ratings.

With respect to the proposal for the suspension or revocation of the registration of an NRSRO after a violation of a rule, the Commission preliminarily believes that it would provide the Commission with more flexibility in determining appropriate sanctions for violations of the securities laws. This could act as a deterrent against violations by NRSROs and could motivate them to strengthen their internal controls to manage conflicts of interest.

The Commission preliminarily believes that codifying these requirements mandated by the Dodd-Frank Act in Rule 17g-5 may promote efficiency. NRSROs should already have developed a system of controls to comply with the existing requirements relating to conflicts of interest that are codified in Rule 17g-5. In addition, the Commission believes proposed paragraph (g) may promote efficiency by incorporating existing processes for sanctioning NRSROs (i.e., those provided for Sections 15E(d) or Section 21C of the Exchange Act).

**2. Costs**

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1113 See Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies, Commission (July 2008), pp. 25-26.

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion with respect to the proposed amendments to Rule 17g-5 would impose minimal incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from the proposed amendments to Rule 17g-5 would be attributable largely to the rulemaking mandated by Dodd-Frank Act.[1114]

The Commission notes that, when it adopted three new absolutely prohibited conflicts by amending paragraph (c) of Rule 17g-5 in 2009, the Commission provided estimates of one-time and annual compliance costs for NRSROs resulting from the amendments.[1115] Moreover, one of those amendments resulted in an absolute prohibition that is similar to the Commission's proposed new absolute prohibition in that it prohibits an NRSRO from issuing or maintaining a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models.[1116] With respect to the 2009 amendments, the Commission estimated that the costs to the three largest NRSROs as a result of the three new prohibited conflicts would be approximately $5,442,100 per firm in one-time costs and $1,563,800 per firm in annual costs.[1117] In addition, the Commission estimated that the costs to the seven smaller NRSROs would be approximately $47,600 per firm in one-time costs and

1114 Compare 15 U.S.C. 78o-7(h)(3)(A), (B)(i), and (B)(ii) with proposed new paragraphs (c)(8), (f), and (g) of Rule 17g-5.

1115 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6479 (February 9, 2009).

1116 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6479 (February 9, 2009) and 17 CFR 240.17g-5(c)(6).

1117 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6479 (February 9, 2009).

$13,760 per firm in annual costs.[1118] The Commission preliminarily believes that the compliance cost for the new absolute prohibition proposed in this release would be proportionally less than the estimates provided above for the three 2009 prohibitions. The Commission also preliminarily believes that granting an exemption from the proposed new absolute prohibition for a small NRSRO that applied in writing for such exemption could reduce potential costs for a smaller NRSRO for which the complete separation of sales and marketing activities from the analytical function would not be appropriate.

The Commission therefore preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new paragraphs (c)(8), (f), and (g) of Rule 17g-5.

### C. "Look-back" Review

Section 932(a)(4) of the Dodd-Frank Act amended Section 15E(h) of the Exchange Act to add a new paragraph (4).[1119] The Commission is proposing to implement the rulemaking required in Section 15E(h)(4)(A)(ii) of the Exchange Act through proposed paragraph (c) of new Rule 17g-8.[1120] Proposed paragraph (c) would require that the policies and procedures the

1118 Id.

1119 See Pub. L. No. 111-203 § 932(a)(4) and 15 U.S.C. 78o-7(h)(4).

1120 See proposed paragraph (c) of new Rule 17g-8; see also Section II.C.1 of this release for a more detailed discussion of this proposal. Sections 15E(h)(4)(A)(i) and (ii) of the Exchange Act require an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to ensure that, in any case in which an employee of a person subject to a credit rating of the NRSRO or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the NRSRO, was employed by the NRSRO and participated in any capacity in determining credit ratings

NRSRO establishes, maintains, and enforces pursuant to Section 15E(h)(4)(A) of the Exchange Act must address instances in which a review conducted pursuant to those policies and procedures determines that a conflict of interest influenced a credit rating assigned to an obligor, security, or money market instrument by including, at a minimum, procedures that are reasonably designed to ensure the NRSRO will: (1) immediately place the credit rating on credit watch; (2) promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest and is solely the product of the NRSRO's documented procedures and methodologies for determining credit ratings; and (3) promptly publish a revised credit rating, if appropriate, or affirm the credit rating if appropriate.[1121]

In addition, the Commission proposes adding paragraph (a)(9) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Exchange Act and proposed paragraph (c) of new Rule 17g-8 as a record an NRSRO must make and retain.[1122] As a result, the policies and procedures would need to be documented in writing and subject to the record retention and production requirements in paragraphs (c) through (f) of Rule 17g-2.[1123]

### 1. Benefits

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for the person or the securities or money market instruments during the 1-year period preceding the date an action was taken with respect to the credit rating, the NRSRO shall: (1) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating; and (2) take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe. See 15 U.S.C. 78o-7(h)(4)(A)(i) and (ii).

1121 See proposed paragraphs (c)(1), (2) and (3) of new Rule 17g-8.

1122 See proposed new paragraph (a)(9) to Rule 17g-2; see also Section II.C.2 of this release for a more detailed discussion of this proposal.

1123 See 17 CFR 240.17g-2(c)-(f).

The Commission preliminarily believes that the proposed look-back review provisions would provide three primary benefits. First, they would implement the rulemaking mandate in a way that would require an NRSRO to notify users of its credit ratings that a prior rating action was subject to a conflict and to review whether the credit rating should be revised. This would help ensure as quickly as possible that the credit rating assigned to the obligor, security, or money market instrument is solely a product of the NRSRO's procedures and methodologies for determining credit ratings. In addition, by prescribing the steps an NRSRO must take to remove the uncertainty surrounding the credit rating, the rule proposal could limit the potential that investors and other users of credit ratings might make investment or other credit based decisions based on incomplete, biased or inaccurate information.

Second, the Commission preliminarily believes that the proposal could operate within the existing framework of an NRSRO's policies and procedures for taking rating actions and procedures and methodologies for determining credit ratings. Placing a rated obligor, security, or money market instrument on credit watch and subsequently affirming or revising (i.e., upgrading or downgrading the rating) are among the rating actions NRSRO's commonly take with respect to their credit ratings. In addition, in terms of revising the conflicted credit rating, the proposal would rely on an NRSRO's policies and procedures for determining credit ratings and not require revisions that are contrary to those policies and procedures. The Commission preliminarily believes that the approach in proposed paragraph (c) of new Rule 17g-8 appropriately avoids regulating the substance of credit ratings or the procedures and methodologies an NRSRO uses to determine credit ratings but, at the same time, requires an

NRSRO to have procedures reasonably designed to ensure that it promptly addresses a credit rating that is subject to a conflict of interest.[1124]

Third, the Commission preliminarily believes that having these policies and procedures in writing would promote better understanding of them among the individuals within the NRSRO and, therefore, promote compliance with the policies and procedures. In addition, the record retention requirements would facilitate Commission oversight of NRSROs. In this regard, recordkeeping rules such as Rule 17g-2 have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws.[1125]

The Commission preliminarily believes that the proposed implementation of Section 15E(h)(4)(A)(ii) of the Exchange Act as mandated by the Dodd-Frank Act may promote efficiency. As noted above, the proposal would be designed to work within the existing processes NRSROs have for taking rating actions and would not interfere with their procedures and methodologies for determining credit ratings.

### 2. Costs

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion with respect to proposed paragraph (c) of new Rule 17g-8 would impose minimal incremental costs. The Commission preliminarily estimates that the costs resulting from

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1124 The Commission also notes an NRSRO would violate Section 15E(h) of the Exchange Act (15 U.S.C. 78o-7(h)) and Rule 17g-5, among other rules, if it continued to assign an obligor, security, or money, market instrument a credit rating that, absent the undue influence of the conflict of interest, would be different because the NRSRO could not be deemed to have policies and procedures reasonably designed to address and manage conflicts of interest that can arise from its business under such a circumstance. See 15 U.S.C. 78o-7(h) and 17 CFR 17g-5.

1125 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33582 (June 18, 2007).

proposed paragraph (c) of new Rule 17g-8 would be attributable largely to the rulemaking mandated by Dodd-Frank Act.[1126] As discussed above in Section IV.D.6, the Commission preliminarily estimates that for PRA purposes, the average annual cost to each NRSRO would be approximately $7,000, resulting in an industry-wide annual cost of approximately $70,000.[1127]

The Commission preliminarily estimates that the costs resulting from the proposed amendment to Rule 17g-2 discussed below largely would be attributable to the Commission's discretionary rulemaking. As discussed above in Section IV.D.3 of this release with respect to the PRA, the Commission preliminary believes applying the recordkeeping requirements of Rule 17g-2 to five new types of records would result in one-time and annual hour burdens for NRSROs in connection with updating their record retention policies and procedures to account for and retain these new records. Also, as discussed above in Section IV.D.3 of this release with respect to the PRA, based on staff experience, the Commission preliminarily estimates that the additional one-time hour burden for each NRSRO to update its record retention policies and procedures to account for the new records that would need to be retained under proposed new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2 would be 20 hours. Based on that estimate, the Commission preliminary believes that the one-time hour burden resulting from proposed new paragraph (a)(9) of Rule 17g-2 would be approximately 4 hours per NRSRO, resulting in an industry-wide hour burden of approximately 40 hours.[1128] As discussed above in Section IV.D.3 of this release with respect to the PRA, the Commission preliminarily estimates it would take an average of approximately one hour each year for an NRSRO to retain updated

1126 Compare 15 U.S.C. 78o-7(h)(4)(A) with proposed paragraph (c) of new Rule 17g-8.

1128 20 hours/5 new required records = 4 hours; 10 NRSROs x 4 hours = 40 hours.

versions of the internal control structure, resulting in an annual industry-wide hour burden of 10 hours.[1129]

The Commission believes that in addition to the compliance costs calculated above for PRA purposes, there could be other potential economic effects resulting from the proposed release that are hard to quantify. For example, former subscribers, who bought on the basis of the original rating but who no longer subscribe to the rating service, would not be notified when a rating has been revised.

For the foregoing reasons, the Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed paragraph (c) of new Rule 17g-8 and proposed new paragraph (a)(9) of Rule 17g-2.

## D. FINES AND OTHER PENALTIES

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new subsection (p), which contains four paragraphs: (1), (2), (3), and (4).[1130] Section 15E(p)(4)(A) provides that the Commission shall establish, by rule, fines and other penalties applicable to any NRSRO that violates the requirements of Section 15E of the Exchange Act and the rules under the Exchange Act.[1131] The Commission proposes to amend the instructions to

[1129] 10 NRSROs x 1 hour = 10 hours.

[1130] See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(p)(1)-(4).

[1131] See 15 U.S.C. 78o-7(p)(4)(A).

Form NRSRO by adding new Instruction A.10.[1132] This new instruction would provide notice to credit rating agencies applying for registration and NRSROs that an NRSRO is subject to the fine and penalty provisions, and other available sanctions contained in Sections 15E, 21, 21A, 21B, 21C, and 32 of the Exchange Act for violations of the securities laws.[1133]

**1. Benefits**

The Commission preliminarily believes this amendment to Form NRSRO would benefit credit rating agencies applying for registration as NRSROs and NRSROs because it would notify them of the potential consequences of violating provisions of the Exchange Act and Commission rules. The Commission also believes that this notification could potentially cause the NRSROs to enhance their compliance and compliance procedures, which would benefit investors and other users of credit ratings. In addition, the Commission believes implementing the rule in this manner would create efficiencies by relying on existing authority to seek fines, penalties, and other available sanctions contained in Sections 15E, 21, 21A, 21B, 21C, and 32 of the Exchange Act for violations of the securities laws.[1134]

**2. Costs**

The Commission preliminarily estimates that the proposed amendment to the instructions to Form NRSRO would not result in additional regulatory obligations for NRSROs. Consequently, the Commission preliminarily believes it would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

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1132 See proposed new Instruction A.10 to Form NRSRO; see also Section II.D of this release for a more detailed discussion of this proposal.

1133 See 15 U.S.C. 78o-7, 15 U.S.C. 78u, 15 U.S.C. 78u-1, 15 U.S.C. 78u-2, 15 U.S.C. 78u-3 and 15 U.S.C. 78ff, respectively.

1134 Id.

Request for Comment

The Commission requests comment on all aspects of the benefits and costs associated with the proposal to amend the instructions to Form NRSRO by adding new Instruction A.10.

## E. PROPOSED ENHANCEMENTS TO DISCLOSURES OF PERFORMANCE STATISTICS

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new subsection (q), which contains paragraphs (1) and (2).[1135] Section 15E(q)(1) provides that the Commission shall, by rule, require each NRSRO to publicly disclose information on the initial credit ratings determined by the NRSRO for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.[1136] Section 15E(q)(2) provides that the Commission's rules shall require, at a minimum, disclosures that, among other things: (1) are comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs;[1137] (2) are clear and informative for investors having a wide range of sophistication who use or might use credit ratings;[1138] (3) include performance information over a range of years and for a variety of types of credit ratings, including for credit ratings withdrawn by the NRSRO;[1139] and (4) are appropriate to the business model of an NRSRO.[1140]

1135 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(q)(1) and (2).

1136 See 15 U.S.C. 78o-7(q)(1).

1137 See 15 U.S.C. 78o-7(q)(2)(A).

1138 See 15 U.S.C. 78o-7(q)(2)(B).

1139 See 15 U.S.C. 78o-7(q)(2)(C).

1140 See 15 U.S.C. 78o-7(q)(2)(E).

The Commission proposes to implement the rulemaking mandated in Section 15E(q) of the Exchange Act, in part, by significantly enhancing the requirements applicable to NRSROs with respect to generating and disclosing performance statistics in Exhibit 1 of Form NRSRO.[1141] Among other things, the amendments would confine the disclosures in the Exhibit to transition and default rates and certain limited supplemental information.[1142] Moreover, the amendments would standardize the production and presentation of the transition and default rates.[1143] Specifically, the amendments would require the transition and default rates in Exhibit 1 to be produced using a "single cohort approach."[1144] Under this approach, an applicant and NRSRO, on an annual basis, would be required to compute how the credit ratings assigned to obligors, securities, and money market instruments in a particular class or subclass of credit rating outstanding on the date 1, 3, and 10 years prior to the most recent calendar year-end performed during those respective 1, 3, and 10-year time periods.[1145]

Under the amendments, the proposed new instructions would be divided into paragraphs (1), (2), (3), and (4), some of which would have subparagraphs.[1146] The proposed new paragraphs would contain specific instructions with respect to, among other things, how required information should be presented in the Exhibit (including the order of presentation) and how transition and default rates should be produced using a single cohort approach.[1147] As with all

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1141 See proposed amendments to Instruction H to Form NRSRO (as it relates to Exhibit 1); see also Section II.E.1.a of this release for a more detailed discussion of this proposal.

1142 See proposed amendments to the instructions for Exhibit 1.

1143 Id.

1144 Id.

1145 Id.

1146 See proposed paragraphs (1)-(4) of the instructions for Exhibit 1.

1147 Id.

information that must be submitted in Form NRSRO and its Exhibits, applicants and NRSROs would be subject to these new requirements.[1148]

The Commission also is proposing implementing Section 15E(q)(2)(D) of the Exchange Act, which requires that the Commission's rules must require NRSROs to make its performance statistics freely available and disclose them on an easily accessible portion of its website, and in writing when requested, by amending paragraph (i) of Rule 17g-1.[1149] The amendment would require an NRSRO to make Form NRSRO and Exhibits 1 through 9 "freely available on an easily accessible portion of its website." The proposed amendment to paragraph (i) also would remove the option for an NRSRO to make its Form NRSRO publicly available "through another comparable, readily accessible means" as an alternative to website disclosure.

**1. Benefits**

Section 15E(q)(1) of the Exchange Act provides that the Commission shall, by rule, require each NRSRO to publicly disclose information on the initial credit ratings determined by the NRSRO for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.[1150] The Commission is proposing to implement this rulemaking mandate, in part, through amendments to the instructions for Exhibit 1 to Form NRSRO. The amendments would be designed to meet the goal in Section 15E(q)(1) that the information disclosed by NRSROs allows users of credit ratings to evaluate the accuracy of credit ratings and compare the performance of credit ratings

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1148 See, e.g., 17 CFR 240.17g-1; see also Instructions A.1, B, C, D, E, and F to Form NRSRO.

1149 A detailed discussion of this proposal is at Section II.E.1.b of this release.

1150 15 U.S.C. 78o-7(q)(1).

by different NRSROs. In this regard, the amendments are designed to make disclosures simply presented, easy to understand, uniform in appearance, and comparable across NRSROs.[1151]

As the Commission stated when originally adopting Form NRSRO, the information provided in Exhibit 1 is an important indicator of the performance of an NRSRO in terms of its ability to assess the creditworthiness of issuers and obligors and, consequently, will be useful to users of credit ratings in evaluating an NRSRO.[1152] The performance statistics required to be disclosed in Exhibit 1 of Form NRSRO were designed to allow users of the credit ratings to compare the credit ratings quality of different NRSROs and, thereby, make it easier for users of credit ratings to compare the ratings performance of the NRSROs. The performance statistics also were designed to allow an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients. In doing so, the Commission believed, the performance statistics would therefore enhance competition in the credit ratings industry.[1153] The proposed amendments to the instructions to Exhibit 1 of Form NRSRO are designed to improve the utility of the required performance statistics disclosure to investors and other users of credit

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1151 See Section 15E(q)(2)(A) of the Exchange Act, which provides that the disclosure of information about the performance of credit ratings should be comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs. 15 U.S.C. 78o-7(q)(2)(A). See also Section 15E(q)(2)(B) of the Exchange Act, which provides that the disclosure of information about the performance of credit ratings should be clear and informative for investors having a wide range of sophistication who use or might use credit ratings. 15 U.S.C. 78o-7(q)(2)(B).

1152 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33574 (June 18, 2007); see also Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6474 (Feb. 9, 2009) ("The amendments to the instructions to Exhibit 1 to Form NRSRO will require NRSROs to provide more detailed performance statistics and, thereby, make it easier for users of credit ratings to compare the performance of the NRSROs. In addition, these amendments will make it easier for an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients.").

1153 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33612 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6474 (Feb. 9, 2009).

ratings and facilitate comparisons between NRSROs, thereby amplifying this positive effect on competition.

In addition, the proposed amendments could improve the Commission's ability to carry out its oversight function for NRSRO which, in turn, would benefit investors. For example, the enhanced utility of the performance statistics provided in an applicant's initial application for registration and in an NRSRO's Form NRSRO could aid the Commission in, among other things, assessing whether the applicant or NRSRO has adequate financial and managerial resources to consistently produce credit ratings with integrity.[1154] Furthermore, the disclosure of the enhanced performance statistics in an applicant's initial application would allow the Commission staff to verify that the applicant, if granted registration, would publicly disclose the information in accordance with the proposed amendments to the Instructions for Exhibit 1.[1155]

In addition, the Commission preliminarily believes that applying the requirement to disclose Form NRSRO and Exhibits 1 through 9 on an "easily accessible" portion of the NRSRO's website would assist investors and other users of credit ratings by making it easier to locate a Form NRSRO. The Commission also believes that amending paragraph (i) to provide

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1154 See, e.g., 15 U.S.C. 78o-7(a)(2)(C) (setting forth grounds to deny an initial application) and 15 U.S.C. 78o-7(d)(1)(E) and (d)(2) (setting forth grounds to sanction an NRSRO, including revoking the NRSRO's registration); see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33612 (June 18, 2007) ("Form NRSRO requires that a credit rating agency provide information required under Section 15E(a)(1)(B) of the Exchange Act and certain additional information. The additional information will assist the Commission in making the assessment regarding financial and managerial resources required under Section 15E(a)(2)(C)(2)(ii)(I) of the Exchange Act.").

1155 As indicated above, paragraph (i) requires an NRSRO to make Form NRSRO and Exhibits 1 through 9 publicly available within 10 business days of being granted an initial registration. See 17 CFR 240.17g-1(i). In addition, the public disclosure of Form NRSRO and Exhibits 1 through 9 could be accelerated if the Commission adopts the proposal that this information be filed through the EDGAR system upon registration.

that Exhibit 1 be made freely available in writing when requested[1156] would benefit those investors who do not have access to the Internet.

The Commission preliminarily believes that enhancing the existing requirements in Exhibit 1 to Form NRSRO is an efficient means of implementing the rulemaking mandated through Section 15E(q) of the Exchange Act. An NRSRO already should have in place information technology systems to meet the existing requirements of the instructions for Exhibit 1 to Form NRSRO, which it could adjust to comply with the proposed new disclosure requirements.

**2. Costs**

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion in proposing amendments to the instructions for Exhibit 1 of Form NRSRO would impose incremental costs. The Commission preliminarily estimates, however, that the costs discussed below would be attributable largely to the rulemaking mandated by the Dodd-Frank Act[1157] and that the incremental costs would be minimal.

An NRSRO should already have in place information technology systems to meet the existing requirements of the instructions to Exhibit 1 of Form NRSRO, which it could adjust to comply with the proposed new disclosure requirements. NRSROs are already subject to substantial performance statistic disclosure requirements, including the requirement to provide transition and default rates in Exhibit 1 for each class of credit rating for which they are registered and for 1, 3, and 10-year periods. The Commission preliminarily believes that

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1156 See proposed amendments to paragraph (i) of Rule 17g-1.

1157 Compare 15 U.S.C. 78o-7(q) with the proposed amendments to the instructions for Exhibit 1 to Form NRSRO; see also GAO Report 10-782, pp. 27-40 (indicating the current requirements for disclosing performance statistics in Exhibit 1 to Form NRSRO may not achieve the objectives of 15 U.S.C. 78o-7(q)).

NRSROs could use the internal information technology systems and expertise and other resources they currently devote to processing the information necessary to monitor credit ratings and calculate transitions and default statistics in order to program a system to comply with the proposed amendments to the Instructions for Exhibit 1.

At the same time, the Commission notes that under the proposed amendments, NRSROs would be required to adhere to specific requirements that may not follow their traditional practices for calculating and presenting transitions and default rates. Consequently, the Commission preliminarily estimates that the proposed amendments requiring standardized Transition/Default Matrices would result in one-time costs to program existing systems to create the Transition/Default Matrices that would be required under the proposed amendments and annual costs to comply with the requirement to update the transition and default rates in Exhibit 1.

As discussed above in Section IV.D.2, the Commission preliminarily believes that the one-time and annual hour burden estimates for implementing these changes should be based on the number of credit ratings outstanding. Based on the annual certifications submitted by the NRSROs for the 2009 calendar year-end, there were approximately 2,905,824 credit ratings outstanding across all 10 NRSROs.[1158] The Commission preliminarily estimates that the one-time industry-wide burden to establish systems to process the relevant information necessary to calculate the Transition/Default Matrices and make the necessary calculations would be an average of approximately 3 seconds per outstanding credit rating, resulting in a one-time industry-wide hour burden of approximately 2,420 hours.[1159]

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1158 Id.

1159 2,905,824 credit ratings x 3 seconds = 2,421.52 hours (rounded to 2,420 hours).

The Commission preliminarily believes that the annual hours burden to comply with the proposed amendments to the Instructions for Exhibit 1 would be less than the one-time burden since the NRSROs would have established systems to process the necessary information to produce the required Transition/Default Matrices. As discussed above in Section IV.D.2 of this release with respect to the PRA, the Commission preliminarily estimates that the annual industry-wide hour burden to calculate the Transition/Default Matrices would be an average of approximately 1.5 seconds per outstanding credit rating, resulting in an industry-wide annual hour burden of approximately 1,210 hours.[1160]

As discussed above in Section IV.D.1 of this release with respect to the PRA, the Commission preliminarily estimates that there would be a minimal one-time hour burden attributable to requiring that an NRSRO make Form NRSRO and Exhibits 1 through 9 freely available on an easily accessible portion of its corporate Internet website and removing the option for an NRSRO to make its Form NRSRO and Exhibits 1 through 9 available through another comparable, readily accessible means. Currently, all NRSROs make Form NRSRO and Exhibits 1 through 9 available on their corporate Internet websites.[1161] However, the Commission preliminarily believes that a Form NRSRO and Exhibits 1 through 9 would be "easily accessible" if they could be accessed through a clearly and prominently labeled hyperlink on the home page of the NRSRO's corporate Internet website. Consequently, NRSROs may need to make changes to their corporate Internet websites to disclose the information on an "easily accessible" portion of the website. The Commission preliminarily estimates re-configuring a corporate Internet website for this purpose would take an NRSRO an average of

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1160 2,905,824 credit ratings x 1.5 seconds = 1,210.76 hours (rounded to 1,210 hours).

1161 See, e.g., Annual Report on Nationally Recognized Statistical Rating Organizations, Commission (Jan. 2011), pp. 18-19.

approximately 5 hours. For these reasons, the Commission preliminarily estimates that the proposed requirement would result in an average one-time hour burden of 5 hours per NRSRO, resulting in a one-time industry-wide hour burden of 50 hours.[1162]

Also as discussed in Section IV.D.1 with respect to the PRA, the Commission expects that the proposed requirement that an NRSRO provide a written copy of Exhibit 1 on request would result in a one-time hour burden for each NRSRO to establish procedures and protocols for receiving and processing these requests. The Commission preliminarily estimates that each NRSRO would spend an average of approximately 48 hours establishing such procedures and protocols, resulting in an industry-wide one-time hour burden of approximately 480 hours.[1163]

Also as discussed in Section IV.D.1 with respect to the PRA, the Commission preliminarily estimates that an NRSRO would receive an average of 200 requests per year to provide Exhibit 1 in writing and that it would take an average of 20 minutes to respond to each request. Therefore, the Commission preliminarily estimates that the average annual hour burden to each NRSRO would be approximately 67 hours, resulting in an annual industry-wide burden of approximately 670 hours.[1164]

In addition, the Commission preliminarily estimates that the incremental cost resulting from implementing the rulemaking mandated by Section 15E(q) of the Exchange Act in this manner would be minimal and, as noted above, the proposal would have substantial benefits. Consequently, the Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Act.

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1162 10 NRSROs x 5 hours = 50 hours.

1163 10 NRSROs x 48 hours = 480 hours.

1164 200 requests x 1/3 hours = 67 hours per NRSRO; 10 NRSROs x 67 hours = 670 hours.

Request for Comment

The Commission requests comment on all aspects of the benefits and costs associated with the proposals to amend the Instructions to Exhibit 1 of Form NRSRO and paragraph (i) of Rule 17g-1.

## F. PROPOSED ENHANCEMENTS TO RATING HISTORIES DISCLOSURES

As discussed above, Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new subsection (q), which contains paragraphs (1) and (2).[1165] In addition to the proposed amendments to the Instructions for Exhibit 1 discussed in the preceding section, the Commission proposes to further implement the rulemaking mandated in Section 15E(q) of the Exchange Act, in part, by adding new paragraph (b) to Rule 17g-7.[1166] This proposed amendment would implement rulemaking mandated in Section 15E(q) of the Exchange Act by: (1) re-codifying in paragraph (b) of Rule 17g-7 requirements currently contained in paragraph (d)(3) of Rule 17g-2; and (2) substantially enhancing those requirements.[1167] More specifically, paragraph (d)(3) of Rule 17g-2 requires an NRSRO to, among other things, make publicly available on its corporate Internet website in an XBRL format the information required to be documented pursuant to paragraph (a)(8) of the rule with respect to any credit rating initially determined by the NRSRO on or after June 26, 2007, the effective date of the Rating Agency Act of 2006.[1168]

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1165 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(q)(1) and (2). See Section

1166 See proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

1167 See 15 U.S.C. 78o-7(q) and proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

1168 17 CFR 240.17-2(d)(3)(i)(A). Paragraph (a)(8) of Rule 17g-2 requires an NRSRO to make and retain a record that, "for each outstanding credit rating, shows all rating actions

These requirements would be enhanced in four ways. The first enhancement would make the disclosure easier for investors and other users of credit ratings to locate. Specifically, new proposed paragraph (b)(1) of Rule 17g-7 would require the NRSRO, among other things, to publicly disclose the ratings history information for free on an easily accessible portion of its corporate Internet website.[1169]

The second enhancement would broaden the scope of credit ratings subject to the disclosure requirements. Specifically, proposed new paragraph (b)(1)(i) of Rule 17g-7 would require an NRSRO to disclose each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the NRSRO is registered that was outstanding as of June 26, 2007 and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument.[1170] With respect to credit ratings initially determined on or after June 26, 2007, the amendments would clarify that the disclosure of the rating history information would be triggered when an NRSRO publishes an initial credit rating, and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any

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and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key ("CIK") number of the rated obligor." 17 CFR 240.17-2(a)(8).

1169 See proposed new paragraph (b)(1) of Rule 17g-7.

1170 See proposed new paragraph (b)(1)(i) of Rule 17g-7.

placements of a credit rating assigned to the obligor, security, or money market instrument on watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument.[1171]

The third enhancement would increase the scope of information that must be disclosed about a rating action. Specifically, proposed paragraph (b)(2) of Rule 17g-7 would identify 7 categories of data that would need to be disclosed when a credit rating action is published pursuant to proposed new paragraph (b)(1) of Rule 17g-7.[1172] The fourth enhancement, contained in proposed new paragraph (b)(5) to Rule 17g-7, would be to require that a rating history not be removed from the disclosure until 20 years after the NRSRO withdraws the credit rating assigned to the obligor, security, or money market instrument.[1173]

**1. Benefits**

Section 15E(q)(1) of the Exchange Act provides that the Commission shall, by rule, require each NRSRO to publicly disclose information on the initial credit ratings determined by the NRSRO for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.[1174] The Commission is proposing to implement this rulemaking mandate, in part, through proposed new paragraph (b) of Rule 17g-7. The amendments would be designed to meet the goal in Section 15E(q)(1) that the information disclosed by NRSROs allows users of credit ratings to evaluate

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1171 See proposed new paragraph (b)(1)(ii) of Rule 17g-7.

1172 See proposed new paragraph (b)(2) of Rule 17g-7.

1173 See proposed new paragraph (b)(5) of Rule 17g-7.

1174 15 U.S.C. 78o-7(q)(1).

the accuracy of credit ratings and compare the performance of credit ratings by different NRSROs.

As the Commission stated when adopting the current ratings history disclosure requirement, the "intent of the rule is to facilitate comparisons of credit rating accuracy across all NRSROs–including direct comparisons of different NRSROs' treatment of the same obligor or instrument—in order to enhance NRSRO accountability, transparency, and competition."[1175] The proposals also are designed to provide persons with the "raw data" necessary to generate statistical information about the performance of each NRSRO's credit ratings.[1176] Finally, the proposals also are designed to implement provisions of Section 15E(q)(2) of the Exchange Act, which provides, among other things, that the Commission's rules shall require NRSROs to disclose information about the performance of credit ratings that is comparable among NRSROs, to allow users of credit ratings to compare the performance of credit ratings across NRSROs.[1177]

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1175 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63838 (Dec. 4, 2009) ("Ratings history information for outstanding credit ratings is the most direct means of comparing the performance of two or more NRSROs. It allows an investor or other user of credit ratings to compare how all NRSROs that maintain a credit rating for a particular obligor or instrument initially rated that obligor or instrument and, thereafter, how and when they adjusted their credit rating over time."). The Commission notes that under the proposals the disclosures would not contain complete histories for many credit ratings because the NRSRO would not need to include information about rating actions taken before June 26, 2007. However, the Commission believes that the disclosures would still be used to compare how different NRSROs rated a particular obligor, security, or money market instrument beginning as of June 26, 2007 and from that date forward.

1176 See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63837-63838 (Dec. 4, 2009) ("The raw data to be provided by NRSROs pursuant to the new ratings history disclosure requirements…will enable market participants to develop performance measurement statistics that would supplement those required to be published by NRSROs themselves in Exhibit 1, tapping into the expertise of credit market observers and participants in order to create better and more useful means to compare the credit ratings performance of NRSROs.").

1177 See 15 U.S.C. 78o-7(q)(2).

The Commission preliminarily believes that implementing the rulemaking mandated through Section 15E(q) of the Exchange Act through proposed new paragraph (b) of Rule 17g-7 would promote an efficient process for NRSROs. An NRSRO already should have in place information technology systems to meet the existing requirements of paragraph (d)(3) of Rule 17g-2, which it could adjust to comply with the proposed new disclosure requirements.

**2. Costs**

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion in proposing new paragraph (b) of Rule 17g-7 would impose incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from the proposed new paragraph would be attributable largely to the rulemaking mandated by Dodd-Frank Act[1178] and that the incremental costs would be minimal.

The Commission preliminarily believes that requiring an NRSRO to make ratings histories available on an "easily accessible" portion of its website would result in the same burden as re-configuring a corporate Internet website for the purpose of making Form NRSRO and Exhibits 1 through 9 "easily accessible." The Commission, therefore, preliminarily believes that the hour burden estimates discussed above in Section V.F.2 of this release with respect to the PRA would be appropriate for estimating the costs resulting from this requirement. Consequently, the Commission preliminarily estimates that requiring an NRSRO to make ratings histories available on an "easily accessible" portion of its corporate Internet website would take

1178 Compare 15 U.S.C. 78o-7(q) with proposed new paragraph (b) of Rule 17g-7; see also GAO Report 10-782, pp. 40-46 (indicating the current requirements of paragraph (d)(3) of Rule 17g-2 may not achieve the objectives of 15 U.S.C. 78o-7(q)).

each NRSRO an average of approximately 5 hours, resulting in a one-time industry-wide hour burden of 50 hours.[1179]

Pursuant to paragraph (d)(3) of Rule 17g-2, NRSROs currently are required to provide ratings history information for each credit rating initially determined on or after June 26, 2007. Proposed new paragraph (b) of Rule 17g-7 would incorporate the requirements currently contained in paragraph (d)(3) of Rule 17g-2 with substantial enhancements that would require NRSROs to add more ratings histories to their disclosures and provide more information about each rating action in the ratings history for each given obligor, security, or money market instrument.[1180] The Commission preliminarily estimates that NRSROs would meet the requirements of new paragraph (b) of Rule 17g-7 by adapting the internal information technology systems and expertise and other resources they currently devote to complying with paragraph (d)(3) of Rule 17g-2, which would result in one-time costs to NRSROs. Consequently, the Commission preliminarily estimates that the proposed amendments would result in one-time costs to reprogram existing systems as well as to add the required information for all credit ratings outstanding as of (as opposed to initially determined on or after) June 26, 2007. As discussed in section IV.D.5 of this release with respect to the PRA, the Commission preliminarily estimates that the proposed enhancements to the current disclosure requirements would result in an average one-time hour burden to each NRSRO of approximately 135 hours, resulting in an industry-wide one-time hour burden of approximately 1,350 hours.[1181] The

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1179 10 NRSROs x 5 hours = 50 hours.

1180 See proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

1181 10 NRSRO x 135 hours = 1,350 hours.

Commission preliminarily believes that NRSROs would implement the required changes internally.

In addition, as discussed in section IV.D.5 of this release with respect to the PRA, the Commission preliminarily estimates that the proposed enhanced disclosure requirements would result in an average annual hour burden per NRSRO of approximately 45 hours, resulting in an industry-wide annual hour burden of approximately 450 hours.[1182]

Finally, the Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the benefits and costs associated with proposed new paragraph (b) of Rule 17g-7.

### G. CREDIT RATING METHODOLOGIES

Section 932(a)(8) of the Dodd-Frank Act amends Section 15E of the Exchange Act to add new subsection (r).[1183] Section 15E(r) of the Exchange Act provides that the Commission shall prescribe rules, for the protection of investors and in the public interest, with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by NRSROs that require each NRSRO to ensure a number of objectives.[1184] The Commission is proposing to implement Section 15E(r) of the Exchange Act through paragraph (a) of proposed new Rule 17g-8.[1185]

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1182 10 NRSRO x 45 hours = 450 hours.

1183 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(r).

1184 See 15 U.S.C. 78o-7(r)(1)-(3).

1185 See proposed paragraph (a) of new Rule 17g-8; see also Section II.F.1 of this release for a

In particular, proposed paragraph (a)(1) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are approved by its board of directors or, if the NRSRO does not have a board of directors, another body performing a function similar to that of a board of directors.[1186] Proposed paragraph (a)(2) would require an NRSRO to have policies and procedures that are reasonably designed to ensure that the procedures and methodologies, including qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are developed and modified in accordance with the policies and procedures of the NRSRO.[1187] Proposed paragraph (a)(3)(i) would require an NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are applied consistently to all credit ratings to which the changed procedures or methodologies apply.[1188] Proposed paragraph (a)(3)(ii) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings, to the extent that the changes are to surveillance or monitoring procedures and methodologies, are applied to then-current credit ratings within a reasonable period of time taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor,

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more detailed discussion of this proposal.

1186 See proposed paragraph (a)(1) of new Rule 17g-8.

1187 See proposed paragraph (a)(2) of new Rule 17g-8.

1188 See proposed paragraph (a)(3)(i) of new Rule 17g-8.

security, or money market instrument being rated.[1189] Proposed paragraph (a)(4)(i) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that the NRSRO promptly publishes on an easily accessible portion of its corporate Internet website material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the NRSRO uses to determine credit ratings, the reason for the changes, and the likelihood the changes will result in changes to any current ratings.[1190] Proposed paragraph (a)(4)(ii) would require the NRSRO to have policies and procedures that are reasonably designed to ensure the NRSRO promptly publishes on its corporate Internet website significant errors identified in a procedure or methodology, including a qualitative or quantitative model, the NRSRO uses to determine credit ratings that may result in a change in current credit ratings.[1191] Finally, proposed paragraph (a)(5) would require the NRSRO to have policies and procedures that are reasonably designed to ensure that it discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[1192]

The Commission also is proposing that the policies and procedures required pursuant to proposed paragraph (a) of new Rule 17g-8 be subject to the record retention and production requirements of Rule 17g-2.[1193] Consequently, the Commission proposes adding new paragraph (b)(13) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish,

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1189 See proposed paragraph (a)(3)(ii) of new Rule 17g-8.

1190 See proposed paragraph (a)(4)(i) of new Rule 17g-8.

1191 See proposed paragraph (a)(4)(ii) of new Rule 17g-8.

1192 See proposed paragraph (a)(5) of new Rule 17g-8.

1193 17 CFR 240.17g-2.

maintain, enforce, and document pursuant to proposed paragraph (a) of new Rule 17g-8 as a record that must be retained.[1194]

### 1. Benefits

The Commission is proposing to implement Sections 15E(r) of the Exchange Act through paragraph (a) of proposed new Rule 17g-8. The Commission preliminarily believes that the proposals would provide several primary benefits for investors and other users of credit ratings. First, having the NRSRO's board of directors or a body performing a function similar to a board approve the NRSRO's procedures and methodologies for determining credit ratings could promote the quality and consistency of the procedures and methodologies.[1195] In addition, taking steps to ensure that such procedures and methodologies are developed and modified pursuant to the NRSRO's policies and procedures also could promote the quality and consistency of the procedures and methodologies.[1196]

Furthermore, taking steps to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the NRSRO uses to determine credit ratings are applied consistently to all credit ratings to which the changed procedures or methodologies apply could promote consistent and timely application of such changes, which could benefit investors and other users of credit ratings.[1197] Similarly, the consistent and timely application of changes to procedures and methodologies for determining credit ratings could be promoted by an NRSRO taking steps to ensure that material changes to the procedures and methodologies, including changes to qualitative and quantitative data and

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1194 See proposed new paragraph (b)(13) to Rule 17g-2; see also Section II.F.2 of this release for a more detailed discussion of this proposal.

1195 See proposed paragraph (a)(1) of new Rule 17g-8.

1196 See proposed paragraph (a)(2) of new Rule 17g-8.

1197 See proposed paragraph (a)(3)(i) of new Rule 17g-8.

models, the NRSRO uses to determine credit ratings are, to the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to then-current credit ratings within a reasonable period of time taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated.[1198]

In addition, the Commission preliminarily believes the proposal would benefit investors and other users of credit ratings by improving the transparency of an NRSRO's procedures and methodologies for determining credit ratings. Specifically, investors and other users of credit ratings would benefit from the transparency arising from requiring that an NRSRO promptly publishes on an easily accessible portion of its corporate Internet website material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the reason for the changes, and the likelihood the changes will result in changes to any current ratings as well as significant errors identified in a procedure or methodology, including a qualitative or quantitative model.[1199] Finally, transparency also would be promoted by requiring that an NRSRO disclose the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[1200]

The Commission preliminarily believes that an additional benefit of the proposal is that implementing Section 15E(r) of the Exchange Act by requiring the NRSRO to have policies and procedures designed to achieve the objectives set forth in that section would provide the NRSRO with flexibility to integrate the required policies and procedure with its procedures and methodologies for determining credit ratings. In other words, the proposal would rely on the

1198 See proposed paragraph (a)(3)(ii) of new Rule 17g-8.

1199 See proposed paragraph (a)(4) of new Rule 17g-8.

1200 See proposed paragraph (a)(5) of new Rule 17g-8.

NRSRO's policies and procedures for determining credit ratings and not require revisions that are contrary to those policies and procedures. The Commission preliminarily believes this approach appropriately avoids regulating the substance of credit ratings or the procedures and methodologies an NRSRO uses to determine credit ratings but, at the same time, requires an NRSRO to have procedures reasonably designed to achieve the objectives set forth in Section 15E(r) of the Exchange Act.

The Commission preliminarily believes this proposed implementation of Section 15E(r) of the Exchange Act would promote an efficient process for NRSROs to comply with the requirements. As noted above, the proposal would be designed to provide the NRSRO with flexibility to integrate the required policies and procedure with its procedures and methodologies for determining credit ratings.

The Commission proposes to further implement Section 15E(r) of the Exchange Act by adding new paragraph (b)(13) to Rule 17g-2 to apply the record retention and production requirements of Rule 17g-2 to the policies and policies and procedures required pursuant to paragraph (a) of proposed new Rule 17g-8.[1201] The record retention requirements would promote efficiency by facilitating Commission oversight of NRSROs. In this regard, recordkeeping rules such as Rule 17g-2 have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws.[1202] Rule 17g–2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is complying with the provisions of Section 15E of the Exchange

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[1201] See 17 CFR 240.17g-2(a), (c), (d), (e) and (f).

[1202] See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR at 33582 (June 18, 2007).

Act and the rules thereunder.[1203] The proposed amendment to Rule 17g-2 is designed to assist the Commission in monitoring an NRSRO's compliance with paragraph (a) of proposed new Rule 17g-8.

### 2. Costs

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion in proposed paragraph (a) of new Rule 17g-8 would impose incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from proposed paragraph (a) of new Rule 17g-8 would be attributable largely to the rulemaking mandated by Dodd-Frank Act[1204] and that the incremental costs would be minimal.

As discussed in Section IV.D.6 of this release with respect to the PRA, the Commission preliminarily estimates that an NRSRO would spend an average of approximately 200 hours establishing the policies and procedures that would be required under paragraph (a) of proposed new Rule 17g-8, resulting in an industry-wide one-time hour burden of approximately 2,000 hours.[1205] In addition, as discussed in Section IV.D.6 of this release with respect to the PRA, the Commission preliminarily estimates an NRSRO would spend an average of approximately 50 hours annually reviewing and updating the policies and procedures required under proposed paragraph (a) of Rule 17g-8, resulting in an annual industry-wide hour burden of approximately 500 hours.[1206]

As noted above, the Commission preliminarily estimates that the costs resulting from proposed new paragraph (b)(13) of new Rule 17g-2 largely would be attributable to the

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1203 Id.

1204 Compare 15 U.S.C. 78o-7(r)(1)-(3), with proposed paragraph (a) of new Rule 17g-8.

1205 10 NRSROs x 200 hours = 2,000 hours.

1206 10 NRSROs x 50 hours = 500 hours.

Commission's discretionary rulemaking. As discussed above in Section IV.D.3 of this release with respect to the PRA, the Commission preliminary believes applying the recordkeeping requirements of Rule 17g-2 to five new types of records would result in one-time and annual hour burdens for NRSROs in connection with updating their record retention policies and procedures to account for and retain these new records. As discussed above in Section IV.D.3 of this release with respect to the PRA, based on staff experience, the Commission preliminarily estimates that the additional one-time hour burden for each NRSRO to update its record retention policies and procedures to account for the new records that would need to be retained under proposed new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2 would be 20 hours. Based on that estimate, the Commission preliminary believes that the average one-time hour burden resulting from proposed new paragraph (b)(13) to Rule 17g-2 would be approximately 4 hours per NRSRO, resulting an industry-wide one-time hour burden of approximately 40 hours.[1207] As discussed above in Section IV.D.3 of this release with respect to the PRA, the Commission preliminarily estimates it would take an average of approximately one hour each year for an NRSRO to retain updated versions of the information required pursuant to paragraph (a) of new Rule 17g-8 resulting in an annual industry-wide burden of 10 hours.[1208]

For the foregoing reasons, Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

[1207] 20 hours/5 new required records = 4 hours; 10 NRSROs x 4 hours = 40 hours.

[1208] 10 NRSROs x 1 hour = 10 hours.

The Commission requests comment on all aspects of the costs and benefits associated with proposed new paragraph (a)(8) of Rule 17g-8 and proposed new paragraph (b)(13) of Rule 17g-2.

## H. FORM AND CERTIFICATION TO ACCOMPANY CREDIT RATINGS

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new paragraph (s).[1209] Sections 15E(s)(1) through (4), among other things, set forth provisions specifying Commission rulemaking with respect to disclosures an NRSRO must make with the publication of a credit rating.[1210] The Commission proposes to implement these provisions by adding new paragraph (a) to Rule 17g-7.[1211] As discussed in detail below, the prefatory text of proposed new paragraph (a) would require an NRSRO to publish two items when taking a rating action: (1) a form containing information about the credit rating resulting from or subject to the rating action;[1212] and (2) any certification of a provider of third-party due diligence services received by the NRSRO that relates to the credit rating.[1213] Proposed paragraph (a)(1) of Rule 17g-7 would contain three primary components: paragraph (a)(1)(i) prescribing the format of the form;[1214] paragraph (a)(1)(ii) prescribing the content of the

1209 See 15 U.S.C. 78o-7(s).

1210 See 15 U.S.C. 78o-7(s)(1)-(4).

1211 See proposed new paragraph (a) of Rule 17g-7 see also Sections II.G.1 through G.5 of this release for a more detailed discussion of this proposal.

1212 See proposed new paragraph (a)(1) of Rule 17g-7. This paragraph would implement, in large part, rulemaking specified in Sections 15E(s)(1), (2), and (3) of the Exchange Act. See 15 U.S.C. 78o-7(s)(1), (2), and (3).

1213 See proposed new paragraph (a)(2) of Rule 17g-7. This paragraph would implement, in part, rulemaking specified in Section 15E(s)(4) of the Exchange Act. See 15 U.S.C. 78o-7(s)(4).

1214 See proposed new paragraph (a)(1)(i) of Rule 17g-7. This paragraph would implement, in large part, rulemaking specified in Section 15E(s)(2) of the Exchange Act. See 15 U.S.C. 78o-7(s)(2).

form;[1215] and paragraph (a)(1)(iii) prescribing an attestation requirement for the form.[1216] Proposed paragraph (a)(2) of Rule 17g-7 would identify the certification from a provider of third-party due diligence services as an item to be published with the rating action.[1217]

### 1. Benefits

The Commission preliminarily believes that the proposed implementation of the rulemaking mandated by Sections 15E(s)(1), (2), (3), and (4)(D) through disclosure requirements in proposed new paragraph (a) of Rule 17g-7 could be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the NRSRO and to determine the adequacy and level of due diligence services provided by a third party with

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1215 See proposed new paragraph (a)(1)(ii) of Rule 17g-7. This paragraph would implement, in large part, rulemaking specified in Section 15E(s)(3) of the Exchange Act. See 15 U.S.C. 78o-7(s)(3). It would also incorporate the existing text of Rule 17g-7 as adopted by the Commission on January 20, 2011 to implement Section 943 of the Dodd-Frank Act. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act of 1933 ("Securities Act") Release No. 9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011) and 17 CFR 240.17g-7.

1216 See proposed new paragraph (a)(1)(iii) of Rule 17g-7. This paragraph would implement, in large part, rulemaking specified in Section 15E(q)(2)(F) of the Exchange Act. See 15 U.S.C. 78o-7(q)(2)(F). Section 15E(q)(2)(F) of the Exchange Act requires that the Commission's rules require an NRSRO to include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument. See 15 U.S.C. 78o-7(q)(2)(F). Proposed paragraph (a)(1)(iii) of Rule 17g-7 would require the NRSRO to attach to the form a signed statement by a person within the NRSRO who has responsibility for the credit rating affirming that: (1) no part of the credit rating was influenced by any other business activities; (2) the credit rating was based solely upon the merits of the instruments being rated; and (3) the credit rating was an independent evaluation of the risks and merits of the instrument. Thus, the proposed requirement would mirror the statutory text in terms of the representations that would need to be made in the attestation. Compare proposed new paragraphs (a)(1)(iii)(A) through (C) of Rule 17g-7, with 15 U.S.C. 78o-7(q)(2)(F).

1217 See proposed paragraph (a)(2) of Rule 17g-7.

respect to an issuance of Exchange Act-ABS.[1218] As the Commission has noted previously, the NRSRO credit ratings of structured finance products such as Exchange Act-ABS played a role in the recent credit crisis.[1219] The proposed information to be disclosed in the form, including information about the limitations of credit ratings and information regarding the due diligence performed on Exchange Act-ABS, could promote more prudent use of credit ratings by investors and other users of credit ratings, and discourage undue reliance by investors and other users of credit ratings in making investment and other credit based decisions.

The Commission preliminarily believes that the proposed implementation of Section 15E(s) of the Exchange Act as mandated by the Dodd-Frank Act may promote efficiency. As noted above, the proposal would be designed to enable investors and other users of credit ratings to better understand the credit ratings and, thereby, promote more prudent use of credit ratings in terms of not unduly relying on credit ratings in making investment and other credit based decisions.

### 2. Costs

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion in proposed new paragraph (a) of Rule 17g-7 would impose incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from the proposed new paragraph (a) of Rule 17g-7 would be attributable largely to the rulemaking mandated by Dodd-Frank Act and that the incremental costs would be minimal.[1220]

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1218 See 15 U.S.C. 78o-7(s)(1)(B).

1219 See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 FR 36212 (June 25, 2008).

1220 Compare 15 U.S.C. 78o-7(s)(1), (2), (3) and (4)(D) with proposed new paragraph (a) of Rule 17g-7.

The Commission preliminarily estimates that proposed new paragraph (a) to Rule 17g-7 would result in a one-time cost to develop the standardized disclosures and establish systems, protocols, and procedures for generating the new information as well as protocols, procedures, and systems designed to ensure that all the information required to be included in the form is input into a form prior to the publication of the credit rating, that any certifications received from a provider of third-party due diligence services are attached to the form, and that the form and certifications are published with the credit rating.

As discussed in above in Section IV.D.5 of this release with respect to the PRA, the Commission preliminarily estimates that the one-time hour burden to develop the required disclosures and establish systems, protocols, and procedures would be approximately 5,000 hours, resulting in a one-time industry-wide hour burden of approximately 50,000 hours.[1221] In addition, the Commission preliminarily allocates 75% of these burden hours (37,500 hours) to internal burden and the remaining 25% (12,500 hours) to external burden to hire outside professionals to assist in setting up the process to generate the forms and publish them with applicable credit ratings.[1222] The Commission preliminarily estimates $273 per hour for internal costs[1223] and $400 per hour for external costs for retaining outside professionals such as attorneys

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1221 10 NRSROs x 5,000 hours = 50,000 hours.

1222 50,000 hours x 0.75 = 37,500 hours; 50,000 hours x 0.25 = 12,500 hours. This allocation is based on the Commission's allocation of the industry-wide hour burden for the amount of time it would take a securitizer to set-up a system to make the disclosures required by Form ABS-15G. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011).

1223 The $273 per hour figure is based on the salary for compliance managers from SIFMA's Management & Professional Earnings in the Securities Industry 2010, 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.

and information technology consultants,[1224] resulting in an industry-wide one-time cost of approximately $15,237,500.[1225]

With respect to the annual costs, the Commission preliminarily believes that the estimate should be broken into two components. The first component would constitute the cost to an NRSRO to update its standardized disclosures. As discussed in above in Section IV.D.5 of this release with respect to the PRA, the Commission preliminarily believes an NRSRO would spend substantially less time updating the disclosures than the one-time estimate of approximately 5,000 hours per NRSRO to initially develop the standardized disclosures and establish the systems, protocols, and procedures to generate the forms. Consequently, the Commission preliminarily estimates that each NRSRO would spend an average of approximately 500 hours per year updating the standardized disclosures, resulting in an annual industry-wide burden of approximately 5,000 hours. The Commission preliminarily believes that the update process would be handled by the NRSROs internally.

The second component would constitute the amount of time an NRSRO would spend generating and publishing each form and attaching to the form applicable certifications. The Commission preliminarily believes this estimate should be based on the number of rating actions taken per year by the NRSROs because the requirement to generate and publish the form and attach the certifications would be triggered upon the taking of a rating action. As discussed above in Section IV.D.5 of this release with respect to the PRA, the Commission preliminarily

[1224] See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

[1225] 37,500 hours x $273 = $10,237,500; 12,500 hours x $400 = $5,000,000; $10,237,500 + $5,000,000 = $15,237,500.

estimates that the 10 NRSROs take approximately 2,909,958 credit rating actions per year.[1226] The Commission preliminarily estimates that the time it would take to generate a form by populating it with the required disclosures (most of which would have been pre-established) and to publish the form and any applicable certifications with the credit rating would be 15 minutes, resulting in an industry-wide annual hour burden of approximately 727,490.[1227] Moreover, although larger NRSROs may realize economies of scale, the Commission preliminarily believes that the annual hour burden would be allocated to the 10 NRSROs based on the number of credit ratings they have outstanding.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new paragraph (a) of Rule 17g-7.

## I. RULE 15GA-2 AND FORM ABS-15G

The Commission is proposing new Rule 15Ga-2 and amendments to Form ABS-15G.[1228] The new rule and amended form would implement Section 15E(s)(4)(A) of the Exchange Act.[1229] Proposed new Rule 15Ga-2 would require an issuer or underwriter of any Exchange Act-ABS that is to be rated by an NRSRO to furnish a Form ABS-15G on the EDGAR system containing the findings and conclusions of any third-party "due diligence report" obtained by the issuer or underwriter. Under the proposal, the disclosure would be furnished using Form ABS-

1226 [2,000,000 credit rating actions constituting upgrades, downgrades, placements on credit watch, and withdrawals] + [4,134 preliminary or expected credit ratings] + [415,117 initial credit ratings] + [490,707 affirmations of existing credit ratings] = 2,909,958 rating actions per year. See Section IV.D.5 of this release for an extensive discussion and explanation of these numbers.

1227 2,909,958 rating actions x .25 hours = 727,489.5 hours (rounded to 727,490 hours).

1228 See proposed new Rule 15Ga-2 and proposed amendments to Form ABS-15G.

1229 See 15 U.S.C. 78o-7(s)(4)(A); see also Section II.H.1 of this release for a more detailed discussion of this proposal.

15G for both registered and unregistered offerings of Exchange Act-ABS. In addition, under the Commission's proposal, an issuer or underwriter would not need to furnish Form ABS-15G if the issuer or underwriter obtains a representation from each NRSRO engaged to produce a credit rating for the Exchange Act-ABS that can be reasonably relied on that the NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7.

### 1. Benefits

The proposed rulemaking would provide a standardized format for an issuer or underwriter to make the disclosures required by Section 15E(s)(4)(A). In addition, the Commission proposes to permit an issuer or underwriter to rely on an NRSRO to make the required disclosure. This would avoid duplicate disclosures. The Commission preliminarily believes these proposals would give effect to the objective in Section 15E(s)(4)(A) of the Exchange Act that there be public disclosure of the findings and conclusions of a provider of third-party due diligence services. In addition to directly using the summaries of due diligence findings contained in the disclosure to evaluate the Exchange Act-ABS, investors and other users of credit ratings could benefit by being able to review that disclosure to determine the adequacy and the level of due diligence services provided by a third party. The required increased transparency regarding the due diligence process could promote greater rigor and discipline in that process, to the benefit of investors. In addition, if no disclosure is made, investors and other users of credit ratings would be put on notice that the issuer or underwriter did not employ a provider of third-party due diligence services in connection with the offering of an Exchange Act-ABS.

The Commission also is proposing amendments to Rule 314 of Regulation S-T that would permit municipal securitizers of Exchange Act-ABS, or underwriters in the offering of municipal Exchange Act-ABS, to provide the information required by Form ABS-15G on EMMA, the Municipal Securities Rulemaking Board's centralized public database.[1230] The Commission preliminarily believes that the use of this pre-existing database would promote an efficient process for municipal securitizers of Exchange Act-ABS or underwriters in the offering of municipal Exchange Act-ABS, who would use it to file the required information, as well as for investors and other market participants, who would use it to access that information. The Commission preliminarily believes that the proposed implementation of Section 15E(s)(4)(A) of the Exchange Act would promote an efficient process for issuers and underwriters by requiring an issuer or underwriter to use a standardized form to make the disclosure. It also would permit an issuer or underwriter to rely on an NRSRO to make the disclosures, thereby eliminating duplicate disclosure requirements.

### 2. Costs

The Commission preliminarily estimates that the costs arising from proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G would be attributable largely to the requirements set forth in Section 15E(s)(4)(A) of the Exchange Act.[1231] Specifically, the Commission believes that the costs to issuers and underwriters arising from preparing a summary of the findings and conclusions of any third-party due diligence report they obtained would be

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[1230] See proposed amendments to Rule 314 of Regulation S-T (17 CFR 231.314); see also Section II.H.1 of this release for a more detailed discussion of this proposal.

[1231] Compare 15 U.S.C. 78o-7(s)(4)(A), with proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G.

directly attributable to the Dodd-Frank Act, while the incremental costs associated with placing such summaries into Form ABS-15G and furnishing the form on EDGAR (or EMMA, as appropriate) would be attributable to the Commission's rulemaking. As noted above, however, the Commission's rulemaking would provide issuers and underwriters with guidelines as to how they can meet the requirements of Section 15E(s)(4)(A) of the Exchange Act, which the Commission believes would eliminate costs that could potentially arise from uncertainty as to how those requirements could be fulfilled.

As discussed above in Section IV.D.9 of this release with respect to the PRA, the Commission preliminarily estimates that proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G would result in one-time and annual costs for issuers and underwriters in offerings of registered and unregistered Exchange Act-ABS.[1232] The Commission preliminarily estimates that issuers and underwriters would incur a one-time cost in connection with developing processes and protocols to provide the required information to comply with new Rule 15Ga-2, including modifying their existing Form ABS-15G processes and protocols to accommodate the requirements of Rule 15Ga-2. In the adopting release for Form

1232 As discussed above in Section IV.D.9, although issuers and underwriters likely will seek to obtain representations from NRSROs engaged to produce a credit rating for Exchange Act-ABS that the NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter with the publication of the credit rating five business days prior to the first sale in the offering in an information disclosure form generated pursuant to proposed new paragraph (a)(1) of Rule 17g-7, thus removing the need for the issuer or underwriter to do so. Consequently, the PRA burden for issuers and underwriters may be reduced substantially. However, to be conservative, the Commission preliminarily allocates the PRA burden for complying with proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G to the issuers and underwriters. The Commission also is proposing to permit issuers of municipal Exchange Act-ABS, or underwriters in such offerings, to provide the information required by Form ABS-15G on EMMA, which would also limit the PRA burden on issuers and underwriters of municipal Exchange Act-ABS subject to the proposed rule.

ABS-15G, the Commission estimated that 270 unique securitizers would be required to file the form.[1233] The Commission preliminarily estimates that each securitizer would spend an average of approximately 100 hours to develop processes and protocols to comply with new Rule 15Ga-2 and to modify their existing Form ABS-15G processes and protocols to provide for the disclosure of the information required pursuant to Rule 15Ga-2, resulting in an industry-wide one-time hour burden of approximately 27,000 hours.[1234] The Commission further believes that this work would be done internally.

As discussed above in Section IV.D.9 of this release with respect to the PRA, the Commission has preliminarily based its estimate of the annual hour burden for preparing and furnishing Form ABS-15G on an estimate of the total number of Exchange Act-ABS offerings per year. In the adopting release for Rule 17g-7, the Commission estimated that there would be an average of approximately 2,067 Exchange Act-ABS offerings per year.[1235] The Commission

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1233 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4506 (Jan. 26, 2011).

1234 270 unique securitizers x 100 hours = 27,000 hours. This estimate is based on the Commission's estimate for the amount of time it would take a securitizer to set up a system to make the disclosures required by Form ABS-15G as originally adopted by the Commission. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011). The Commission, however, believes that the hour burden for amending existing Form ABS-15G processes and protocols will be significantly lower than the estimate of 850 hours used to initially develop those processes and protocols.

1235 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4508 (Jan. 26, 2011). As noted above, issuers, underwriters, and NRSROs may not use providers of third-party due diligence services with respect to every issuance of Exchange Act-ABS. For example, as discussed in Section II.H of this release, the Commission preliminarily believes that providers of third-party due diligence services are used primarily for RMBS transactions. However, the Commission's estimate uses the total number of estimated Exchange Act-ABS offerings (as opposed to a lesser amount based on an estimate of RMBS offerings) because the use of providers of third-party due diligence services may migrate to other types of Exchange Act-ABS. This also makes the Commission's estimates more conservative.

preliminarily estimates that an issuer or underwriter would spend an average of approximately one hour completing and submitting each Form ABS-15G for purpose of meeting the requirement in Rule 15Ga-2. The Commission bases this preliminary estimate on the fact that the information that would be required to be included in Form ABS-15G pursuant to proposed new Rule 15Ga-2 could be drawn directly from the due diligence reports the Commission expects providers of third-party due diligence services to generate with respect to their performance of due diligence services. Therefore, the Commission preliminarily estimates that the industry-wide annual hour burden resulting from proposed new Rule 15Ga-2 and the amendments to Form ABS-15G would be approximately 2,067 hours.[1236] The Commission believes that this work would be done internally.

The Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G.

**J. THIRD-PARTY DUE DILIGENCE FOR ASSET-BACKED SECURITIES**

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new paragraph (s)(4).[1237] The Commission is proposing new Rule 17g-10 and new Form ABS Due Diligence-15E to implement rulemaking mandated in Sections 15E(s)(4)(B) and (C) of the Exchange Act.[1238] Proposed new Rule 17g-10 would contain three paragraphs: (a), (b) and

1236 2,067 Exchange Act-ABS transactions x 1 hour = 2,067 hours.

1237 See Pub. L. No. 111-203 § 932(a)(8) and 15 U.S.C. 78o-7(s)(4).

1238 See proposed new Rule 17g-10, and proposed new Form ABS Due Diligence-15E; see (c).[1239] Proposed paragraph (a) would provide that the written certification of a provider of third-party due diligence services required pursuant to Section 15E(s)(4)(B) of the Exchange Act must be made on Form ABS Due Diligence-15E.[1240] Proposed paragraph (b) of new Rule 17g-10 would provide that the written certification must be signed by an individual who is duly authorized by the person providing the third-party due diligence services to make such a certification.[1241] Proposed paragraph (c) of new Rule 17g-10 would contain four definitions to be used for the purposes of Section 15E(s)(4)(B) and Rule 17g-10; namely, a definition of "due diligence services,"[1242] "issuer,"[1243] "originator,"[1244] and "securitizer."[1245]

Proposed Form ABS Due Diligence-15E would contain five line items identifying information the provider of third-party due diligence services would need to provide in the form.[1246] It also would contain a signature line with a corresponding representation.[1247] Item 1 would elicit the identity and address of the provider of third-party due diligence services.[1248] Item 2 would elicit the identity and address of the issuer, underwriter, or NRSRO that employed

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also Sections II.H.2 and II.H.3 of this release for a more detailed discussion of this proposal.

1239 See proposed paragraphs (a), (b) and (c) of Rule 17g-10 see also Sections II.H.2 of this release for a more detailed discussion of this proposal.

1240 See proposed paragraph (a) of new Rule 17g-10.

1241 See proposed paragraph (b) of Rule 17g-10.

1242 See proposed paragraph (c)(1) of new Rule 17g-10.

1243 See proposed paragraph (c)(2) of new Rule 17g-10.

1244 See proposed paragraph (c)(3) of new Rule 17g-10.

1245 See proposed paragraph (c)(4) of new Rule 17g-10.

1246 See proposed new Form ABS Due Diligence-15E; see also Section II.H.3 of this release for a more detailed discussion of this proposal.

1247 See proposed new Form ABS Due Diligence-15E.

1248 See Item 1 to proposed Form ABS Due Diligence-15E.

the provider of third-party due diligence services.[1249] Item 3 would instruct the provider of third-party due diligence services to identify each NRSRO whose published criteria for performing due diligence the provider of third-party due diligence services satisfied in performing the due diligence review.[1250] Item 4 would require the provider of third-party due diligence services to describe the scope and manner of the due diligence performed.[1251] Item 5 would require the provider of third-party due diligence services to describe the findings and conclusions resulting from the review.[1252]

### 1. Benefits

The proposed rulemaking would be designed to promote a thorough review by the provider of third-party due diligence services of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate credit rating.[1253] The Commission also preliminarily believes that, in combination with the proposed requirement in proposed new paragraph (a)(2) of Rule 17g-7 that the NRSRO disclose the certifications, the proposed rulemaking would allow the public to determine the adequacy and level of due diligence services provided by a third party.

The Commission preliminarily believes that the proposed implementation of Section 15E(s)(4)(C) of the Exchange Act as mandated by the Dodd-Frank Act would promote an efficient process for NRSROs by establishing a standardized format for the certification and

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1249 See Item 2 to proposed Form ABS Due Diligence-15E.

1250 See Item 3 to proposed Form ABS Due Diligence 15E.

1251 See Item 4 to proposed Form ABS Due Diligence 15E.

1252 See Item 5 to proposed Form ABS Due Diligence 15E.

1253 See 15 U.S.C. 78o-7(s)(4)(B).

providing clarity through the definition of "due diligence services" as to when the requirement was triggered.

### 2. Costs

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion with respect to proposed new Rule 17g-10 and new Form ABS Due Diligence-15E would impose incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from proposed new Rule 17g-10 and new Form ABS Due Diligence-15E would be attributable largely to the rulemaking mandated by Dodd-Frank Act[1254] and that the incremental costs would be minimal.

As discussed above in Section IV.D.8 of this release with respect to the PRA, the Commission preliminarily estimates that the proposed new rule and form would result in one-time hour burdens for providers of third-party due diligence services to develop processes and protocols to provide the required information in new Form ABS Due Diligence-15E and submit the certifications to NRSROs. The Commission preliminarily estimates that there are approximately 10 firms that provide, or would begin providing, third-party "due diligence services" to issuers and underwriters of Exchange Act-ABS as the term "due diligence services" would be defined in paragraph (a) of proposed new Rule 17g-10. The Commission preliminarily estimates that each of these providers of third-party due diligence services would spend approximately 300 hours to develop these processes and protocols, resulting in a one-time industry-wide burden of 3,000 hours.[1255] In addition, the Commission preliminarily allocates

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[1254] Compare 15 U.S.C. 78o-7(s)(4)(B) and (C), with proposed new Rule 17g-10 and proposed new Form ABS Due Diligence-15E.

[1255] 10 Providers of third-party due diligence services x 300 hours = 3,000 hours. This estimate is based on the Commission's estimate for the amount of time it would take a securitizer to set up a system to make the disclosures required by Form ABS-15G as

75% of these burden hours (2,250 hours) to internal burden and the remaining 25% (750 hours) to external burden to hire outside attorneys to provide legal advice on the requirements of new Rule 17g-10 and Form ABS Due Diligence-15E.[1256] The Commission, therefore, preliminarily estimates that the average one-time cost to each provider third-party due diligence services would be $91,425, resulting in an industry-wide one-time cost of $914,250.[1257]

With respect to the annual cost, the Commission preliminarily believes that the estimate should be based on the number of issuances per year of Exchange Act-ABS, since the requirement to produce the certification and provide it to NRSROs would be triggered when an issuer, underwriter, or NRSRO hires a provider of third-party due diligence services with respect to such transactions.[1258] In the adopting release for Rule 17g-7, the Commission estimated there would be an average of approximately 2,067 Exchange Act-ABS offerings per year.[1259] In

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originally adopted by the Commission. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011). The Commission, however, reduces the hour estimate of 850 hours originally used for Form ABS-15G by approximately two-thirds because information required to provided in proposed new Form ABS Due Diligence-15E is substantially less detailed and complex than the information required in Form ABS-15G as initially adopted by the Commission.

1256 3,000 hours x 0.75 = 2,250 hours; 3,000 hours x 0.25 = 750 hours.

1257 2,250 hours x $273 = $614,250; 750 hours x $400 = $300,000; $614,250 + $300,000 = $914,250; $914,250/10 providers of third-party due diligence services = $91,250. The $273 per hour figure is based on the rate for compliance managers from SIFMA's Management & Professional Earnings in the Securities Industry 2010, 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. The $400 figure is based on the Commission's estimate of $400 per hour to engage an outside attorney. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009).

1258 See 15 U.S.C. 78o-7(s)(4)(B) and (C), and proposed new Rule 17g-10.

1259 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4508 (Jan. 26, 2011). The Commission notes that issuers, underwriters, and NRSROs may not use providers of third-party due diligence services with respect to every issuance of Exchange Act-ABS.

addition, the Commission preliminarily estimates that a provider of third-party due diligence services would spend approximately 30 minutes completing and submitting Form ABS Due Diligence-15E. The Commission bases this preliminary estimate on the fact that first three Items in the form require basic information and the fourth Item (the due diligence performed) and the fifth Item (the findings and conclusions of the review) could be drawn directly from the due diligence reports the Commission expects providers of third-party due diligence services generate with respect to their performance of due diligence services. Therefore, the Commission preliminarily estimates that the industry-wide annual hour burden resulting from proposed new Rule 17g-10 and Form ABS Due Diligence-15E would be approximately 1,034 hours.[1260] The Commission believes that completing and submitting Form ABS Due Diligence-15E would be done internally.

The Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new Rule 17g-10 and new Form ABS Due Diligence-15E.

## K. STANDARDS OF TRAINING, EXPERIENCE, AND COMPETENCE

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For example, as discussed in Section II.H of this release, the Commission preliminarily believes that providers of third-party due diligence services are used primarily for RMBS transactions. However, the Commission's estimate uses the total number of estimated Exchange Act-ABS offerings (as opposed to a lesser amount based on an estimate of RMBS offerings) because the use of providers of third-party due diligence services may migrate to other types of Exchange Act-ABS. This also makes the Commission's estimates more conservative.

1260 2,067 Exchange Act-ABS offerings x 30 minutes = 1,034 hours.

Section 936 of the Dodd-Frank Act provides that the Commission shall issue rules that are reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings: (1) meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates;[1261] and (2) is tested for knowledge of the credit rating process.[1262] The Commission proposes to implement Section 936 by proposing new Rule 17g-9 and amending Rule 17g-2.[1263]

Proposed paragraph (a) of new Rule 17g-9 would require an NRSRO to establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings that are reasonably designed to achieve the objective that such individuals produce accurate credit ratings in the classes and subclasses of credit ratings for which the NRSRO is registered.[1264]

Proposed paragraph (b) would identify factors the NRSRO must consider when designing the standards.[1265] Specifically, the NRSRO would need to consider:

- If the credit rating procedures and methodologies used by the individual involve qualitative analysis, the knowledge necessary to effectively evaluate and process the data relevant to the creditworthiness of the obligor being rated or the issuer of the securities or money market instruments being rated;

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1261 See Pub. L. No. 111-203 § 936(1).

1262 See Pub. L. No. 111-203 § 936(2).

1263 See proposed new Rule 17g-9 and proposed new paragraph (b)(15) of Rule 17g-2.

1264 See proposed paragraph (a) of new Rule 17g-9; see also Section II.I.1.a of this release for a more detailed discussion of this proposal.

1265 See proposed paragraph (b) of new Rule 17g-9; see also Section II.I.1.b of this release for a more detailed discussion of this proposal.

- If the credit rating procedures and methodologies used by the individual involve quantitative analysis, the technical expertise necessary to understand any models and model inputs that are a part of the procedures and methodologies;
- The classes and subclasses of credit ratings for which the individual participates in determining credit ratings and the factors relevant to such classes and subclasses, including the geographic location, sector, industry, regulatory and legal framework, and underlying assets, applicable to the obligors or issuers in the classes and subclasses; and
- The complexity of the obligors, securities, or money market instruments being rated by the individuals.

Proposed paragraph (c) of new Rule 17g-9 would prescribe two requirements that an NRSRO must incorporate into its standards of training, experience, and competence.[1266] Proposed paragraph (c)(1) of new Rule 17g-9 would provide that the standards of training, experience, and competence must include a requirement for periodic testing of the individuals employed by the NRSRO to determine credit ratings on their knowledge of the procedures and methodologies used by the NRSRO to determine credit ratings in the classes or subclasses of credit ratings for which the individual is responsible for determining credit ratings.[1267] Proposed paragraph (c)(2) of new Rule 17g-9 would provide that the standards of training, experience, and competence must include a requirement that at least one individual with three years or more experience in performing credit analysis participates in the determination of a credit rating.[1268]

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1266 See proposed paragraphs (c)(1) and (2) of new Rule 17g-9; see also Section II.I.1.c of this release for a more detailed discussion of this proposal.

1267 See proposed paragraph (c)(1) of new Rule 17g-9.

1268 See proposed paragraph (c)(2) of new Rule 17g-9.

In addition, the Commission proposes adding new paragraph (b)(15) to Rule 17g-2 to identify the standards of training, experience, and competence the NRSRO must establish, maintain, enforce, and document pursuant to proposed new Rule 17g-9 as a record that must be retained.[1269] As a result, the procedures would be subject to the record retention and production requirements in paragraphs (c) through (f) of Rule 17g-2.[1270]

**1. Benefits**

The Commission is proposing to implement rulemaking mandated by Section 936 of the Dodd-Frank Act through proposed new Rule 17g-9. The proposed rule would be designed to achieve the objectives in Section 936 that any person employed by an NRSRO to perform credit ratings: (1) meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates;[1271] and (2) is tested for knowledge of the credit rating process.[1272] The Commission preliminarily believes that the proposed new rule could promote the integrity of the ratings process to the benefit of investors and other users of credit ratings.

Paragraph (a) of proposed new Rule 17g-9 would require the NRSRO to design its own standards but provide that they must be reasonably designed to achieve the common objective that individuals employed by the NRSRO to determine credit ratings produce accurate credit ratings in the classes of credit ratings for which the NRSRO is registered. This could benefit NRSROs by providing flexibility to allow each NRSRO to customize the standards according to its unique procedures and methodologies for determining credit ratings and its size.

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1269 See proposed new paragraph (b)(15) to Rule 17g-2.

1270 See 17 CFR 240.17g-2; see also Section II.I.2 of this release for a more detailed discussion of this proposal.

1271 See Pub. L. No. 111-203 § 936(1).

1272 See Pub. L. No. 111-203 § 936(2).

Paragraph (b) of proposed new Rule 17g-9 would identify factors the NRSRO must consider when designing the standards.[1273] This would provide guidance to NRSROs about the Commission's expectations for the design of the standards of training, experience, and competence. It also could serve an investor protection function by providing benchmarks that Commission examiners could use to evaluate whether a given NRSRO's standards are reasonably designed to meet the objective that individuals employed by the NRSRO to determine credit ratings produce accurate credit ratings in the classes of credit ratings for which the NRSRO is registered.

Paragraph (c)(1) of proposed new Rule 17g-9 would provide that the standards of training, experience, and competence must include a requirement for periodic testing of the individuals employed by the NRSRO to determine credit ratings on their knowledge of the procedures and methodologies used by the NRSRO to determine credit ratings in the classes or subclasses of credit ratings for which the individual participates in determining credit ratings.[1274] The rule could benefit NRSROs by allowing each NRSRO to establish the frequency and manner of testing its analysts. These considerations may depend on the number of analysts the NRSRO employs, the complexity of the products that are being rated, and the varying levels of experience of the analysts.

Paragraph (c)(2) of proposed new Rule 17g-9 would provide that the standards of training, experience, and competence must include a requirement that at least one individual with three years or more experience in performing credit analysis participates in the determination of

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1273 See proposed paragraph (b) of new Rule 17g-9.

1274 Id.

a credit rating.[1275] This would establish a minimum requirement that someone with experience performing credit analysis is involved in determining the credit rating.

**2. Costs**

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion with respect to proposed new Rule 17g-9 would impose incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from proposed new Rule 17g-9 would be attributable largely to the rulemaking mandated by Dodd-Frank Act and that the incremental costs would be minimal.[1276]

As discussed above in Section IV.D.7 of this release with respect to the PRA, the Commission preliminary estimates that an NRSRO would incur one-time and annual hour burdens as a result of proposed new Rule 17g-9. Also, the Commission preliminarily estimates that the degree of the one-time and annual hour burdens resulting from proposed Rule 17g-9 would depend on the number of credit analysts an NRSRO employs as well as the range and complexity of the obligors, securities, and money market instruments it rates. Thus, hour burdens in the PRA and the costs estimated below are based on the number of credit rating analysts employed by the NRSROs.

As discussed above in Section IV.D.7 of this release with respect to the PRA, the Commission preliminarily estimates that the one-time hour burden to establish the standards that would be required under proposed new Rule 17g-9 would be approximately 5 hours per credit analyst. Based on the 2009 annual certifications, the Commission estimates that the NRSROs currently employ approximately 3,520 credit analysts,[1277] resulting in an industry-wide one-time

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1275 Id.

1276 Compare Pub. L. No. 111-203 § 936 with proposed new Rule 17g-9.

1277 See Figure 3.

hour burden of 17,600 hours.[1278] In addition, the Commission estimates that 75% of the burden hours (13,200 hours) would be internal and the remaining 25% (4,400 hours) would be external to hire outside professionals to assist in setting up training programs.[1279] Consequently, the Commission preliminarily estimates that the industry-wide one-time internal cost would be approximately $3,603,000.[1280] With respect to the external costs associated with the proposal, the Commission preliminarily estimates that outside professionals would charge approximately $400 per hour.[1281] Consequently, the Commission preliminarily estimates that the industry-wide external cost would be approximately $1,760,000.[1282] The Commission, therefore, preliminarily estimates that the total industry-wide one-time cost of proposed Rule 17g-9 would be approximately $5,363,000.[1283] The Commission preliminarily estimates that this cost would be allocated to the 10 NRSROs based on the number of credit analysts each employs.

As discussed above in Section IV.D.7 of this release with respect to the PRA, the Commission believes that the annual cost to comply with proposed new Rule 17g-9 would be less than the one-time cost since NRSROs already would have established the standards of training, experience, and competence for the individuals they employ to determine credit ratings

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1278 3,520 credit analysts x 5 hours = 17,600 hours.

1279 17,600 hours x 0.75 = 13,200 hours; 17,600 hours x 0.25 = 4,400 hours.

1280 13,200 hours x $273 = $3,603,600. The $273 per hour figure is based on the rate for compliance managers from SIFMA's Management & Professional Earnings in the Securities Industry 2010, 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.

1281 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

1282 4,400 hours x $400 = $1,760,000.

1283 $1,760,000 + $3,603,000 = $5,363,000.

and, therefore, only would need to update them. The Commission preliminarily estimates that reviewing and updating the standards as appropriate would take approximately 1 hour per credit analyst, resulting in an annual industry-wide hour burden of approximately 3,520 hours.[1284] The Commission estimates that approximately 75% of these burden hours (2,640 hours) would be internal and the remaining 25% (880 hours) would be external to hire outside professionals to assist in updating the training programs. Consequently, the Commission preliminarily estimates that the industry-wide annual internal costs would be approximately $720,720.[1285] With respect to the external costs, the Commission preliminarily estimates that outside professionals would charge approximately $400 per hour.[1286] Consequently, the Commission preliminarily estimates that the annual industry-wide external costs would be approximately $352,000.[1287] The Commission, therefore, preliminarily estimates that the total industry-wide annual cost would be approximately $1,072,720.[1288] The Commission preliminarily estimates that this cost would be allocated to the 10 NRSROs based on the number of credit analysts each employs.

The Commission acknowledges that the three-year analyst experience requirement proposed in paragraph (c)(2) of proposed new Rule 17g-9 could impose a barrier to entry to

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1284 3,520 credit analysts x 1 hour = 3,520 hours.

1285 2,640 hours x $273 = $720,720. The $273 per hour figure is based on the rate for compliance managers from SIFMA's Management & Professional Earnings in the Securities Industry 2010, 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.

1286 See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR at 4507-4506 (Jan. 26, 2011) (providing an estimate of $400 an hour engage outside professionals) and Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 FR 63889 (Dec. 4, 2009) (providing an estimate of $400 per hour to engage an outside attorney).

1287 880 hours x $400 = $352,000.

1288 $720,720 + $352,000 = $1,072,072.

becoming an NRSRO. It is possible that this requirement, as well as the increased training standards in general, could increase labor costs for NRSROs by increasing the competition for credit analysts with the requisite amount of experience. The Commission further understands that the effects could likely be more pronounced with existing smaller NRSROs, as well as with new NRSRO entrants, as these smaller firms would presumably be less able to bear the costs. This could, in turn, decrease competition amongst NRSROs. The Commission requests comment on this potential effect of the proposed rulemaking.

The Commission preliminarily estimates that, although the costs resulting from proposed new paragraph (b)(15) of new Rule 17g-2 would be attributable to the Commission's discretionary rulemaking, those incremental costs would be minimal. As discussed above in Section IV.D.3 of this release with respect to the PRA, the Commission preliminary believes that applying the recordkeeping requirements of Rule 17g-2 to five new types of records would result in one-time and annual hour burdens for NRSROs in connection with updating their record retention policies and procedures to retain these new records. As discussed above in Section IV.D.3 of this release with respect to the PRA, based on staff experience, the Commission preliminarily estimates that the additional one-time hour burden for each NRSRO to update its record retention policies and procedures for the new records that would need to be retained under proposed new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2 would be 20 hours. Based on that estimate, the Commission preliminary believes that the average one-time hour burden attributable to proposed new paragraph (b)(15) of Rule 17g-2 would be approximately 4 hours per NRSRO, resulting in an industry-wide hour burden of approximately 40 hours.[1289] As discussed above in Section IV.D.3 of this release with respect to the PRA, the

1289 20 hours/5 new required records = 4 hours; 10 NRSROs x 4 hours = 40 hours.

Commission preliminarily estimates it would take an average of approximately one hour each year for an NRSRO to retain updated versions of the information required pursuant to proposed new paragraph (b)(15) of Rule 17g-2, resulting in an industry-wide hour burden of 10 hours.[1290]

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new Rule 17g-9 and new paragraph (b)(15) of Rule 17g-2.

## L. UNIVERSAL RATING SYMBOLS

Section 938(a) of the Dodd-Frank Act provides that the Commission shall require, by rule, each NRSRO to establish, maintain, and enforce written policies and procedures that: (1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;[1291] (2) clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating;[1292] and (3) apply any symbol described in item (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.[1293]

The Commission proposes to implement this rulemaking mandate through paragraph (b) of proposed new Rule 17g-8. In particular, paragraph (b)(1) of proposed new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the

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1290 10 NRSROs x 1 hour = 10 hours.

1291 See Pub. L. No. 111-203 § 938(a)(1).

1292 See Pub. L. No. 111-203 § 938(a)(2).

1293 See Pub. L. No. 111-203 § 938(a)(3).

security or money market instrument.[1294] Paragraph (b)(2) of proposed new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to clearly define the meaning of each symbol, number, or score in the rating scale used by the NRSRO to denote a credit rating category and notches within a category for each class and subclass of credit ratings for which the NRSRO is registered and to include such definitions in Exhibit 1 to Form NRSRO.[1295] Paragraph (b)(3) of proposed new Rule 17g-8 would require the NRSRO to have policies and procedures reasonably designed to apply any symbol, number, or score defined pursuant to paragraph (b)(2) of new Rule 17g-8 in a manner that is consistent for all types of obligors, securities, and money market instruments for which the symbol, number, or score is used.[1296]

The Commission also is proposing that the policies and procedures required pursuant to proposed paragraph (b) of new Rule 17g-8 be subject to the record retention and production requirements of Rule 17g-2.[1297] Consequently, the Commission proposes adding new paragraph (b)(14) to Rule 17g-2 to identify the policies and procedures an NRSRO is required to establish, maintain, enforce, and document pursuant to proposed paragraph (b) of new Rule 17g-8 as a record that must be retained.[1298]

### 1. Benefits

The proposal could facilitate investor understanding of credit ratings by promoting a consistent application of rating methodologies to particular credit ratings, at least within a class

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1294 See proposed paragraph (b)(1) of new Rule 17g-8.

1295 See proposed paragraph (b)(2) of new Rule 17g-8.

1296 See proposed paragraph (b)(1) of new Rule 17g-8.

1297 17 CFR 240.17g-2.

1298 See proposed new paragraph (b)(13) to Rule 17g-2; see also Section II.F.2 of this release for a more detailed discussion of this proposal.

of credit ratings. In addition, the proposed requirement for NRSROs to disclose the meaning of credit rating symbols, numbers, and scores could benefit investors and other users of credit ratings by promoting a better understanding of credit rating terminology and allowing them to better compare the various ratings issued by a single NRSRO.

### 2. Costs

The Commission preliminarily estimates that the Commission's exercise of rulemaking discretion with respect to proposed paragraph (b) of new Rule 17g-8 would impose incremental costs. However, the Commission preliminarily estimates that the costs discussed below resulting from proposed paragraph (b) of new Rule 17g-8 would be attributable largely to the rulemaking mandated by Dodd-Frank Act[1299] and that the incremental costs would be minimal.

As discussed in above in Section IV.D.6 with respect to the PRA, the Commission preliminarily estimates each NRSRO would spend an average of approximately 200 hours establishing the policies and procedures that would be required under paragraph (b) of proposed new Rule 17g-8, resulting in an industry-wide one-time hour burden of 2,000 hours.[1300] In addition, as discussed in above in Section IV.D.6 with respect to the PRA, the Commission preliminarily estimates an NRSRO would spend an average of approximately 50 hours annually reviewing and updating those policies and procedures, resulting in an industry-wide annual burden of 500 hours.[1301]

The Commission preliminarily estimates that, although the costs resulting from proposed new paragraph (b)(14) of new Rule 17g-2 would be attributable to the Commission's discretionary rulemaking, those incremental costs would be minimal. As discussed above in

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1299 Compare Pub. L. No. 111-203 § 938, with proposed new Rule 17g-9.

1300 10 NRSROs x 200 hours = 2000 hours.

1301 10 NRSROs x 50 hours = 500 hours.

Section IV.D.3 of this release with respect to the PRA, the Commission preliminary believes applying the recordkeeping requirements of Rule 17g-2 to five new types of records would result in one-time and annual hour burdens for NRSROs in connection with updating their record retention policies and procedures to account for and retain these new records. As discussed above in Section IV.D.3 of this release with respect to the PRA, based on staff experience, the Commission preliminarily estimates that the additional one-time hour burden for each NRSRO to update its record retention policies and procedures to account for the new records that would need to be retained under proposed new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2 would be 20 hours. Based on that estimate, the Commission preliminary believes that the average one-time hour burden attributable to proposed new paragraph (b)(14) of Rule 17g-2 would be approximately 4 hours per NRSRO, resulting in an industry-wide hour burden of approximately 40 hours.[1302]

As discussed above in Section IV.D.3 of this release with respect to the PRA, the Commission preliminarily estimates it would take an average of approximately one hour each year for an NRSRO to retain updated versions of the information required pursuant to proposed new paragraph (b)(14) of Rule 17g-2, resulting in an industry-wide hour burden of 10 hours.[1303]

The Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed paragraph (b) of new Rule 17g-8.

1302 20 hours/5 new required records = 4 hours; 10 NRSROs x 4 hours = 40 hours.

1303 10 NRSROs x 1 hour = 10 hours.

## M. ANNUAL REPORT OF DESIGNATED COMPLIANCE OFFICER

Section 932(a)(5) of the Dodd-Frank Act amended Section 15E(j) of the Exchange Act to re-designate paragraph (j) as paragraph (j)(1) and to add new paragraphs (j)(2) through (j)(5).[1304] Section 15E(j)(1) of the Exchange Act contains a self-executing provision that an NRSRO designate an individual responsible for administering the policies and procedures that are required to be established pursuant to Sections 15E(g) and (h) of the Exchange Act,[1305] and for compliance with the securities laws and the rules and regulations thereunder, including those promulgated by the Commission under Section 15E of the Exchange Act.[1306] Section 15E(j)(5)(A) of the Exchange Act requires the designated compliance officer to submit to the NRSRO an annual report on the compliance of the NRSRO with the securities laws and the policies and procedures of the NRSRO that includes: (1) a description of any material changes to the code of ethics and conflict of interest policies of the NRSRO; and (2) a certification that the report is accurate and complete.[1307] Section 15E(j)(5)(B) of the Exchange Act provides that the NRSRO shall file the report required pursuant to Section 15E(j)(5)(A) together with the financial report that is required to be submitted to the Commission under Section 15E of the Exchange Act.[1308]

As discussed above in Section II.A.3 of this release, Rule 17g-3 requires an NRSRO to submit five or, in certain cases, six separate reports not more than 90 days after the end of the

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1304 See 15 U.S.C. 78o-7(j)(1) though (5).

1305 See 15 U.S.C 780-7(g) and (h).

1306 See 15 U.S.C. 78o-7(j)(1).

1307 See 15 U.S.C. 78o-7(j)(5)(A).

1308 See 15 U.S.C. 78o-7(j)(5)(B).

NRSRO's fiscal year and identifies the reports to be submitted to the Commission.[1309] In order to further clarify the self-executing requirement in Section 15E(j)(5)(B) of the Exchange Act, the Commission is proposing to amend Rule 17g-3 to identify the annual report of the designated compliance officer as one of the reports that must be submitted to the Commission.[1310] Specifically, the Commission proposes adding a new paragraph (a)(8) to Rule 17g-3 to identify the report on the compliance of the NRSRO with the securities laws and the policies and procedures of the NRSRO required pursuant to Section 15E(j)(5)(B) of the Exchange Act.[1311]

The Commission preliminarily estimates that the costs and benefits of this proposal are entirely attributable to the mandates of the Dodd-Frank Act, and are not a result of decisions made by the Commission to fulfill the mandates of the Dodd-Frank Act within its permitted discretion. Proposed new paragraph (a)(8) to Rule 17g-3 is intended only to clarify how an NRSRO must adhere to the self-executing provisions in Section 15E(j)(5)(B) of the Exchange Act and would result in no additional costs. Moreover, the Commission is not proposing to add any additional requirements with respect to the filing other than the proposed requirement that this report and the other annual reports be filed through the EDGAR system, which is addressed separately below.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with proposed new paragraph (a)(8) to Rule 17g-3.

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1309 See 17 CFR 240.17g-3(a)(1)-(6). As discussed above in Section II.A.3 of this release, the Commission is proposing that Rule 17g-3 be amended to add a new paragraph (a)(7) to implement Section 15E(c)(3)(B) of the Exchange Act by requiring an NRSRO to file the annual internal controls report. See 15 U.S.C. 78o-7(c)(3)(B).

1310 See proposed new paragraph (a)(8) of Rule 17g-3.

1311 Id.

### N. Electronic Submission of Form NRSRO and the Rule 17g-3 Annual Reports

The Commission is proposing that certain Form NRSRO submissions and all Rule 17g-3 annual report submissions be submitted to the Commission using the EDGAR system. In order to implement this requirement, the Commission is proposing amendments to Rule 101 of Regulation S-T to require the electronic submission using the EDGAR system of Form NRSRO pursuant to paragraphs (e), (f), and (g) of Rule 17g-1 and the annual reports pursuant Rule 17g-3.[1312] The Commission also is proposing to amend Rule 201 of Regulation S-T, which governs temporary hardship exemptions from electronic filing, to make this exemption unavailable for NRSRO submissions.[1313]

#### 1. Benefits

One of the primary goals of the EDGAR system since its inception is to facilitate the rapid dissemination of financial and business information in connection with filings the Commission receives. Although paragraph (i) of Rule 17g-1 currently requires NRSROs to make the public portions of their current Form NRSROs publicly available within 10 business days after submission to the Commission, the Commission believes that having all such information available immediately upon submission in one location would make the information more easily available and searchable to investors and other users of credit ratings. Further, the Commission believes that submissions made to the Commission are more valuable to investors and other users of credit ratings if they are available in electronic form and that adding the Form NRSRO submissions to the EDGAR database would provide a more complete picture for the public. The Commission preliminarily estimates that, as a result of the proposals, the EDGAR

1312 See proposed amendment of Rule 101 of Regulation S-T (17 CFR 231.101); see also Section II.L of this release for a more detailed discussion of this proposal.

1313 See proposed amendment of Rule 201 of Regulation S-T (17 CFR 231.201); see also Section II.L of this release for a more detailed discussion of this proposal.

page of the Commission's website,[1314] in conjunction with the NRSRO page of the Commission's website,[1315] would be a comprehensive source from which to find most public information submitted to the Commission, as well as other information, related to NRSROs. The Commission preliminarily believes that the electronic submission of Form NRSRO would benefit investors and other users of credit ratings by increasing the efficiency of retrieving and comparing NRSRO public submissions and enabling the investors and other users of credit ratings to access information more quickly.

In addition, while the Rule 17g-3 annual reports would not be made public on EDGAR, having them submitted on EDGAR would assist the Commission in its oversight of NRSROs. For example, Commission examiners could easily retrieve the annual reports of a specific NRSRO to prepare for an examination. Moreover, having these records submitted and stored through EDGAR in a centralized location would assist the Commission from a records management perspective by establishing a more automated storage process and creating efficiencies in terms of reducing the volume of paper submissions that must be manually processed and stored.

Moreover, the Commission preliminarily believes that the electronic submission of the Form NRSROs and the Rule 17g-3 annual reports would benefit NRSROs. For example, NRSROs would avoid the uncertainties, delay, and expense related to the manual delivery of paper submissions. Further, NRSROs would benefit from no longer having to submit multiple paper copies of these submissions to the Commission.

The Commission preliminarily believes that the proposed requirement that Form NRSROs and Exhibits 1 through 9 and the Rule 17g-3 annual reports be submitted through the

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1314 http://www.sec.gov/investor/pubs/edgarguide.htm.

1315 www.sec.gov/divisions/marketreg/ratingagency.htm.

EDGAR system would promote efficiency. As noted above, the proposal would provide a central location for an investor or other user of credit ratings to access the Forms and Exhibits. It also would assist the Commission staff in storing and accessing these records in furtherance of the Commission's NRSRO oversight function. Furthermore, it would provide NRSROs with a more efficient way to submit these forms and reports to the Commission.

**2. Costs**

The Commission preliminarily estimates that, although the Commission's exercise of rulemaking discretion with respect to the proposed amendments to Rules 101 and 201 of Regulation S-T, Rule 17g-1, and Rule 17g-3 would impose incremental costs, those incremental costs would be minimal.

As discussed in Section IV.D.1 of this release with respect to the PRA, the Commission preliminarily estimates that each NRSRO would spend an average of approximately 5 hours becoming familiar with the EDGAR filing system and completing and submitting Form ID.[1316] The Commission preliminarily estimates that the annual cost attributable to submitting the Form NRSROs and Rule 17g-3 annual reports through the EDGAR system would be no greater than the annual costs attributable to submitting them in paper form.

The Commission preliminarily believes any incremental cost resulting from the amendments would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

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1316 An NRSRO would need to complete Form ID in order to be eligible to submit documents using the EDGAR system. However, completing Form ID is a simple process. The Commission has noted in the past that the burden associated with Form ID is 15 minutes. See Securities Exchange Act Release No. 57280 (Feb. 6, 2008), 73 FR 10592, 10610 (Feb. 27, 2008). Thus, the Commission preliminarily estimates that the one-time hour burden per NRSRO associated with the filing of Form ID would be 15 minutes, resulting in an industry-wide burden of 1.5 hours.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with the proposed amendments to Rules 101 and 201 of Regulation S-T, Rule 17g-1, and Rule 17g-3.

### O. OTHER AMENDMENTS

The Commission is proposing additional amendments to several of the NRSRO rules in response to amendments the Dodd-Frank Act made to sections of the Exchange Act that authorize or otherwise are relevant to these rules. The Commission preliminarily estimates that these proposals would not result in any one-time or annual incremental costs to NRSROs. Furthermore, the Commission preliminarily believes these proposals would benefit NRSROs and Commission staff be making terms in Commission rules applicable to NRSROs consistent with terms in Section 15E of the Exchange. This could promote greater clarity as to the requirements in the rules and remove potential ambiguity caused by inconsistent terms.

The Commission preliminarily believes that the proposals would promote efficiency. As noted above, the proposals would be designed to promote greater clarity as to the requirements in the rules and remove potential ambiguity caused by inconsistent terms. In addition, as discussed above, the Commission preliminarily estimates that the proposals would not result in any one-time or annual incremental costs to NRSROs and would have substantial benefits. Consequently, the Commission preliminarily believes that the proposals would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

#### 1. Changing "Furnish" to "File"

In accordance with the Dodd-Frank Act, the Commission is proposing amending certain provisions of Rule 17g-1 and Rule 17g-3 to replace the word "furnish" with the word "file."[1317] The Commission also is proposing to make conforming amendments to Form NRSRO and the instructions for Form NRSRO.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with these proposed amendments, including whether they would result in one-time or annual incremental costs to NRSROs.

**2. Amended Definition of "NRSRO"**

The definition of "nationally recognized statistical rating organization" in Section 3(a)(62) of the Exchange Act, prior to being amended by the Dodd-Frank Act, included a condition in Section 3(a)(62)(A) that the entity "has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under Section 15E."[1318] Section 932(b) of the Dodd-Frank Act struck subparagraph (A) of Section 3(a)(62).[1319] Form NRSRO contains a definition of "NRSRO" that tracks Section 3(a)(62) as originally enacted. The Commission proposes amending this definition to conform it

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1317 See Section II.M.1 of this release.

1318 See Section 3(a)(62)(A) of the Exchange Act (15 U.S.C. 78c(a)(62)(A)) added by the Rating Agency Act of 2006.

1319 The Dodd-Frank Act did not, however, amend Section 15E(a)(1)(C), which requires that the certifications from qualified institutional buyers that are required to be submitted with an application for registration as an NRSRO under Section 15E(a)(1)(B), include a representation that the qualified institutional buyer "has used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification in the subject category or categories of obligors."

to Section 3(a)(62) as amended by the Dodd-Frank Act.[1320] The Commission does not believe these proposals would result in any incremental costs to NRSROs.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with these proposed amendments, including whether they would result in one-time or annual incremental costs to NRSROs.

### 3. Definition of Asset-backed Security

Section 941(a) of the Dodd-Frank Act amended Section 3 of the Exchange Act to add Section 3(a)(77), which defines "asset-backed security."[1321] In response, the Commission is proposing that certain language in Exchange Act Rules 17g-2(a)(2)(iii); 17g-2(a)(7); 17g-5(a)(3); 17g-5(b)(9); 17g-6(a)(4); and Form NRSRO be amended to reflect this new definition.[1322] The Commission preliminarily estimates that these proposals would result in no incremental costs to NRSROs.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with these proposed amendments, including whether they would result in one-time or annual incremental costs to NRSROs.

### 4. Other Amendments to Form NRSRO

The Commission is proposing a number of additional amendments to the Instructions to Form NRSRO to clarify certain requirements because the instructions, as written, have created some confusion among NRSROs. The Commission preliminarily estimates that these proposals

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1320 See Section II.M.2 of this release.

1321 15 U.S.C. 78c(a)(77).

1322 See Section II.M.3 of this release.

would not result in any one-time or annual incremental costs to NRSROs as they would clarify existing requirements (not create new requirements). Furthermore, the Commission preliminarily believes these proposals would benefit NRSROs and Commission staff by addressing parts of the instructions that have led to inconsistent interpretations among the NRSROs as to the requirements.

The Commission preliminarily believes that the proposals would promote efficiency. As noted above, the proposals would be designed to promote greater clarity as to the requirements in the instructions. In addition, as discussed above, the Commission preliminarily estimates that the proposals would not result in any one-time or annual incremental costs to NRSROs and would have substantial benefits. Consequently, the Commission preliminarily believes that the proposals would not impact competition or impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

**a. Clarification with Respect to Items 6 and 7**

The Commission is proposing amendments to Form NRSRO and the Instructions for Form NRSRO to remove potential ambiguity as to how an applicant and NRSRO must determine the approximate number of credit ratings outstanding for the purposes of Items 6 and 7. In particular, the Commission is proposing to amend the text in Items 6.A and 7.A of Form NRSRO to clarify that an applicant or NRSRO must provide the approximate number of obligors, securities, and money market instruments in each class of credit ratings for which the applicant or NRSRO has an outstanding credit rating.[1323]

In addition, the Commission is proposing to amend Instruction H to Form NRSRO (as it relates to Items 6.A and 7.A) in four ways. First, in conformity with the proposed amendments

[1323] See proposed amendments to the text in Items 6.A and 7.A respectively.

to the text of Items 6.A and 7.A in the Form, the Instructions would be amended to provide that the applicant or NRSRO must, for each class of credit ratings, provide in the appropriate box the approximate number of obligors, securities, and money market instruments in that class for which the applicant or NRSRO presently has a credit rating outstanding as of the date of the application (Item 6.A) or had a credit rating outstanding as of the end of the most recently ended calendar year (Item 7.A).

Second, Instruction H would be amended to provide that the applicant or NRSRO must treat as a separately rated security or money market instrument each individually rated security and money market instrument that, for example, is assigned a distinct CUSIP or other unique identifier, has distinct credit enhancement features as compared with other securities or money market instruments of the same issuer, or has a different maturity date as compared with other securities or money market instruments of the same issuer. This proposed instruction would be designed to clarify that each security or money market instrument of an issuer must be included in the count if it is assigned a credit rating by the applicant or NRSRO.

Third, Instruction H would be amended to provide that the applicant or NRSRO must not include an obligor, security, or money market instrument in more than one class of credit rating. In other words, the applicant or NRSRO cannot double count an obligor, security, or money market instrument by including it in total credit ratings outstanding for two or more classes. Fourth, Instruction H would be amended to provide that the applicant or NRSRO must include in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Exchange Act (issuers of asset-backed securities) to the extent not described in Section 3(a)(62)(B)(iv), any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction. As discussed above in Section II.M.3 of this release, Section 3(a)(62)(B)(iv) contains a narrower definition of "asset-backed security" than the Commission uses for the purposes of its NRSRO rules.[1324]

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with these proposed amendments, including whether they would result in one-time or annual incremental costs to NRSROs.

### b. Clarification with Respect to Exhibit 8

The Commission proposes to amend Instruction H to Form NRSRO as it relates to Exhibit 8. Exhibit 8 requires an applicant and NRSRO to provide the number of credit analysts it employs and the number of credit analyst supervisors. The Commission is proposing two amendments to the instructions for Exhibit 8. The first amendment would delete a parenthesis in the instructions that provides that the applicant or NRSRO should "see definition below" of the term "credit analyst." There is no such definition. The second amendment would clarify that the applicant or NRSRO, in providing the number of credit analysts, should include the number of credit analyst supervisors. This would be designed to ensure that the disclosures in Form NRSRO are comparable across NRSROs by avoiding the situation in which some NRSROs include credit analyst supervisors in the total number of credit analysts and some NRSROs do not include credit analyst supervisors in that amount.

Request for Comment

1324 Compare 15 U.S.C. 78c(a)(62)(B)(iv) with: Instructions for Exhibit 1 to Form NRSRO; paragraphs (a)(2)(iii), (a)(7), and (b)(9) of Rule 17g-2; paragraph (a)(6) of Rule 17g-3; paragraphs (a)(3) and (b)(9) of Rule 17g-5; and paragraph (a)(4) of Rule 17g-6.

The Commission requests comment on all aspects of the costs and benefits associated with these proposed amendments, including whether they would result in one-time or annual incremental costs to NRSROs.

### c. Clarification with Respect to Exhibits 10 through 13

The Commission proposes to amend Instruction H in several places to add a "Note" instructing that after registration, Exhibits 10 through 13 are not required to be made publicly available by the NRSRO pursuant to Rule 17g-1(i) and they should not be updated with the filing of the annual certification. The "Note" further would instruct that similar information is required in the annual reports that must be filed with the Commission not more than 90 days after the end of each fiscal year under Rule 17g-3.[1325]

The Commission preliminarily believes that none of these proposed clarifications entail any changes to the existing requirements of the Commission's rules, but instead merely explain more clearly what those rules already require. Therefore, Commission does not attribute any costs or benefits to these clarifications.

Request for Comment

The Commission requests comment on all aspects of the costs and benefits associated with these proposed amendments, including whether they would result in one-time or annual incremental costs to NRSROs.

## VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[1326] the Commission must advise OMB as to whether the proposed regulation

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[1325] See "Notes" proposed to be added to Instruction H to Form NRSRO.

[1326] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. 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 amendments to existing rules and proposed new 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 view to the extent possible.

## VII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared this Initial Regulatory Flexibility Analysis (IRFA) in accordance with Section 603(a) of the Regulatory Flexibility Act (RFA).[1327] This IRFA relates to the Commission's proposed new requirements for NRSROs that would result from the amendments to Rule 101 of Regulation S-T, Rule 201 of Regulation S-T, Rule 17g-1, Rule 17g-2, Rule 17g-3, Rule 17g-5, Rule 17g-6, Rule 17g-7, and Form NRSRO, and proposed new Rule 17g-8 and new Rule 17g-9. In addition, the IRFA relates to the Commission's proposed new requirements for providers of third-party due diligence services that would result from new Rule 17g-10 and new Form ABS Due Diligence-15E. Finally, this IRFA relates to the Commission's proposed new requirements for issuers and underwriters of Exchange Act-ABS that would result from the amendments to Rule 314 of Regulation S-T and Form ABS-15G, and new Rule 15Ga-2.

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1327 See 5 U.S.C. 603(a).

## A. REASONS AND OBJECTIVES

Section II of this release describes the reasons and objectives of the proposed amendments to existing rules and proposed new rules. In addition, Section IV.B of this release describes the intended use of the collection of information requirements that would result from the proposed amendments to existing rules and proposed new rules. Moreover, as described in Section II of this release, these proposed amendments and proposed new rules would implement rulemaking mandated in Title IX, Subtitle C of the Dodd-Frank Act.[1328] In Section 931 of Title IX, Subtitle C of the Dodd-Frank Act, Congress made the following findings:

- Because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators, the activities and performances of credit rating agencies, including NRSROs, are matters of national public interest, as credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy.[1329]
- Credit rating agencies, including NRSROs, play a critical ''gatekeeper'' role in the debt market that is functionally similar to that of securities analysts, who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.[1330]
- Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial ''gatekeepers'' do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of

1328 See Pub. L. No. 111-203 §§ 931-939H.

1329 Pub. L. No. 111-203 § 931(1).

1330 Pub. L. No. 111-203 § 931(2).

liability and oversight as apply to auditors, securities analysts, and investment bankers.[1331]

- In certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation in order to give clearer authority to the Securities and Exchange Commission.[1332]
- In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.[1333]

## B. LEGAL BASIS

The Commission's proposed amendments to existing rules and proposed new rules are made pursuant to the Exchange Act,[1334] particularly Sections 15E, 17(a) and 36 of the Exchange Act,[1335] and Sections 936 and 938(a) of the Dodd-Frank Act.[1336]

## C. SMALL ENTITIES SUBJECT TO THE RULE

### 1. NRSROs and Providers of Third-Party Due Diligence Services

1331 Pub. L. No. 111-203 § 931(3).

1332 Pub. L. No. 111-203 § 931(4).

1333 Pub. L. No. 111-203 § 931(5).

1334 15 U.S.C. 78a et seq.

1335 15 U.S.C. 78o–7, 78q and 78mm.

1336 Pub. L. No. 111-203 §§ 936 and 938(a).

Under section 601(3) of the RFA, the term "small business" is defined as having "the same meaning as the term 'small business concern' under Section 3 of the Small Business Act, unless an agency, after consultation with the Office of Advocacy of the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register."[1337] The Commission's rules do not define "small business" or "small organization" with respect to NRSROs. However, paragraph (a) of Rule 0-10 provides that for purposes of the RFA, a small entity "[w]hen used with reference to an 'issuer' or a 'person' other than an investment company" means "an 'issuer' or 'person' that, on the last day of its most recent fiscal year, had total assets of $5 million or less."[1338] The Commission has stated in the past that an NRSRO with total assets of $5 million or less would qualify as a "small" entity for purposes of the RFA.[1339] The Commission continues to believe this threshold of total assets of $5 million or less would qualify an NRSRO as "small" for purposes of the RFA. In addition, the Commission preliminarily believes this would be an appropriate threshold for determining whether a provider of third-party due diligence services is "small" for purposes of the RFA.

Currently, there are 10 NRSROs and, based on their most recently filed annual reports pursuant to Rule 17g-3, one NRSRO is a small entity under the above definition. For purposes of the PRA, the Commission preliminarily estimates that there will be 10 providers of third-party

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1337 5 U.S.C. 601(3).

1338 17 CFR 240.0-10(a).

1339 See e.g., Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 FR 33618 (June 18, 2007); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 6481 (Feb. 9, 2009); and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 FR at 63863 (Dec. 4, 2009).

due diligence services subject to the proposed new requirements.[1340] Of these 10 respondents, the Commission estimates that all 10 would be "small" entities.

### 2. Issuers and Underwriters

The proposing release for Form ABS-15G certified that the form would not have a significant economic impact on a substantial number of small entities.[1341] As discussed above in Section V.I.2 of this release, the Commission believes that the costs to the issuers and underwriters subject to proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G would be less than those arising from the adoption of Form ABS-15G. The Commission, therefore, certifies pursuant to 5 U.S.C. 605(b) that proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G contained in this release, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposals relate to disclosure requirements for Exchange Act-ABS. As noted above, Rule 0-10(a)[1342] defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. The Commission's data indicates that only one sponsor could meet the definition of a small broker-dealer for purposes of the Regulatory Flexibility Act.[1343] Accordingly, the Commission does not believe that proposed new Rule 15Ga-2 and the proposed amendments to Form ABS-15G, if adopted, would have a significant economic impact on a substantial number of small entities.

## D. REPORTING, RECORDKEEPING, AND OTHER COMPLIANCE REQUIREMENTS

1340 See Section VI.C of this release.

1341 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. 9148 (Oct. 4, 2010), 75 FR 62718 at 62734 (Oct. 13, 2010).

1342 17 CFR 240.0-10(a).

1343 This is based on data from Asset-Backed Alert.

The proposed amendments and proposed new rules would impose certain reporting, recordkeeping, and other compliance requirements on small NRSROs and small providers of third-party due diligence services. Preliminary estimates of the costs attributable to these proposals are discussed in detail in Section V of this release. As discussed in Section V of this release, the Commission preliminarily estimates that the costs are largely attributable to rulemaking mandates in the Dodd-Frank Act and not to the exercise of Commission discretionary rulemaking.

The Commission is providing summary information below about the preliminary cost estimates in Section V of this release to estimate the impact the proposals would have on the one small NRSRO and the 10 small providers of third-party due diligence services. In some cases, the Commission preliminarily believes it is appropriate to estimate the one-time and annual costs per small NRSRO using average costs across all NRSROs that would be subject to the proposed amendments and new rules. The NRSROs vary, in terms of size and complexity, from small entities that employ less than 20 credit analysts to complex global organizations that employ over a thousand credit analysts.[1344] Given the variance in size between the largest NRSROs and the smallest NRSROs, the average costs are skewed higher because the largest firms currently dominate in terms of size and the volume of credit rating activities.[1345] In other cases, as described below, the Commission preliminarily believes it is appropriate to estimate the one-time

1344 See, e.g., Annual Report on Nationally Recognized Statistical Rating Organizations. Commission (Jan. 2011), pp. 4-9.

1345 As discussed above in Section IV.D of this release, based on data collected from the NRSROs in their Form NRSROs and Rule 17g-3 annual reports, the Commission has calculated an HHI number using the number credit ratings outstanding per NRSRO and that number is 3,495, which is equivalent to there being approximately 2.86 equally sized firms. The HHI using earnings reported by NRSROs in the Rule 17g-3 annual reports is 3,926, which the equivalent of 2.55 equally sized firms.

and annual costs per small NRSRO based on the number of credit ratings outstanding or the number of credit analysts employed by the seven smaller NRSROs.[1346] In a cost estimate based on the number of credit ratings outstanding, the Commission preliminarily proposes to use the number of credit ratings outstanding of the 7 smaller NRSROs.[1347] In a cost estimate based on the number of credit analysts, the Commission preliminarily proposes to use the number of credit analysts employed by the 7 smaller NRSROs.[1348]

As discussed above in Section V.A.2 of this release, the Commission preliminarily estimates that the proposed amendments to Rule 17g-3 would result in one-time and annual costs to NRSROs.[1349] In particular, the Commission preliminarily estimates that the proposal would result in an average one-time cost to each NRSRO of approximately $40,000 and an average annual cost to each NRSRO of approximately $60,950.[1350]

As discussed above in Section V.B.2 of this release, the Commission preliminarily estimates that the proposed amendments to Rule 17g-5 would result in one-time and annual costs

1346 The seven smaller NRSROs are: A.M. Best Company, Inc., DBRS Ltd., Egan-Jones Rating Company, Japan Credit Rating Agency, Ltd., Kroll Bond Rating Agency, Inc. (formerly LACE Financial Corp.), Rating and Investment Information, Inc., and Realpoint LLC. See Figures 2 and 3. The small NRSRO is one these NRSROs.

1347 80,648 (total credit ratings outstanding for the seven smaller NRSROs) / 2,905,825 (total credit ratings outstanding for all ten NRSROs) / 7 (the number of smaller NRSROs) = 0.00396. See Figure 2.

1348 370 (the total number of credit analysts employed by the seven smaller NRSROs) / 3,520 (the total number of credit analysts employed by all ten NRSROs) / 7 (the number of smaller NRSROs) = .01502. See Figure 3.

1349 See proposed new paragraph (a)(7) and proposed amendments to paragraph (b) of Rule 17g-3; see also Section II.A.1 of this release for a more detailed discussion of these provisions.

1350 See Section V.A.2 of this release for a more detailed discussion of the basis for these cost estimates.

to each NRSRO.[1351] Moreover, the Commission provides separate preliminary cost estimates for the three larger NRSROs and the seven smaller NRSROs. In particular, the Commission preliminarily estimates that the proposal would result in an average one-time cost to each of the seven smaller NRSROs of approximately $15,867 and an average annual cost to each of the seven smaller NRSROs of approximately $4,587.[1352]

As discussed above in Section V.C.2 of this release, the Commission preliminarily estimates proposed paragraph (c) to new Rule 17g-8 would result in one-time and annual costs to each NRSRO.[1353] In particular, the Commission preliminarily estimates that the proposal would result in an average one-time cost to each NRSRO of approximately $27,300 and an average annual cost to each NRSRO of approximately $6,825.[1354]

As discussed above in Section V.E.2 of this release, the Commission preliminarily estimates that the proposed amendments to the instructions to Exhibit 1 of Form NRSRO would result in one-time and annual costs to each NRSRO.[1355] Based on the total number of ratings outstanding across all 10 NRSROs, the Commission preliminarily estimates an industry-wide one-time cost of approximately $735,680 and an industry-wide annual cost of approximately $367,840.[1356] Moreover, because of the wide variance in the number of credit ratings

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1351 See proposed new paragraph (c)(8) of Rule 17g-5; see also Section II.B.1 of this release for a more detailed discussion of this proposal.

1352 See Section V.B.2 of this release for a more detailed discussion of the basis for these cost estimates.

1353 See proposed paragraph (c) of new Rule 17g-8; see also Section II.C.1 of this release for a more detailed discussion of this proposal.

1354 See Section V.C.2 of this release for a more detailed discussion of the basis for these cost estimates.

1355 See proposed amendments to Instruction H to Form NRSRO (as it relates to Exhibit 1); see also Section II.E.1.a of this release for a more detailed discussion of this proposal.

1356 See Section V.E.2 of this release for a more detailed discussion of the basis for these cost outstanding among the NRSROs, the Commission preliminarily believes that it is appropriate to allocate these costs to NRSROs based on the number of credit ratings each has outstanding (although larger NRSROs may realize economies of scale). Consequently, the Commission preliminarily estimates that the proposal would result in an average one-time cost to the small NRSRO of approximately $2,913 and an average annual cost to the small NRSRO of approximately $1,457.[1357]

As discussed above in Section V.E.2 of this release, the Commission preliminarily estimates that the proposed amendments to Rule 17g-1 would result in one-time and annual costs to each NRSRO.[1358] First, the Commission preliminarily estimates that the proposal to require an NRSRO to it make its Form NRSRO and Exhibits 1 through 9 freely available on an "easily accessible" portion of its corporate Internet website would result in an average one-time cost to each NRSRO of approximately $1,125.[1359] Second, the Commission preliminarily estimates that the proposal to require an NRSRO to provide, when requested, a written copy of Exhibit 1 would result in an average one-time cost to each NRSRO of approximately $13,104 and an average annual cost to each NRSRO of approximately $18,291.[1360]

As discussed above in Section V.F.2 of this release, the Commission preliminarily estimates that proposed new paragraph (b) of Rule 17g-7 would result in one-time and annual

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estimates.

1357 $735,680 x .00396 = $2,913.29, rounded to $2,913; $367,840 x .00396 = $1,456.65, rounded to $1,457..

1358 See proposed amendments to paragraph (i) of Rule 17g-1; see also Section II.E.1.b of this release for a more detailed discussion of this proposal.

1359 See Section V.E.2 of this release for a more detailed discussion of the basis for this cost estimate.

1360 Id.

costs to each NRSRO.[1361] First, the Commission preliminarily estimates that the proposal to make the ratings histories available on an "easily accessible" portion of the NRSRO's corporate Internet website would result in an average one-time cost to each NRSRO of approximately \$1,125.[1362] Second, the Commission preliminarily estimates that the proposed enhancements to the current ratings history disclosure requirements would result in an average one-time cost to each NRSRO of approximately \$30,375 and an average annual cost to each NRSRO of approximately \$10,125.[1363]

As discussed above in Section V.G.2 of this release, the Commission preliminarily estimates that paragraph (a) of proposed new Rule 17g-8 would result in one-time and annual costs to each NRSRO.[1364] In particular, the Commission preliminarily estimates that the proposal would result in an average one-time cost to each NRSRO of approximately \$54,600 and an average annual cost to each NRSRO of approximately \$13,650.[1365]

As discussed above in Section V.H.2 of this release, the Commission preliminarily estimates that proposed new paragraph (a) of Rule 17g-7 would result in one-time and annual costs to each NRSRO.[1366] Based on the total number of ratings outstanding across all 10 NRSROs, the Commission preliminarily estimates an industry-wide one-time cost of

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1361 See proposed new paragraph (b) of Rule 17g-7; see also Section II.E.2 of this release for a more detailed discussion of this proposal.

1362 See Section V.F.2 of this release for a more detailed discussion of the basis for this cost estimate.

1363 See Section V.F.2 of this release for a more detailed discussion of the basis for these cost estimates.

1364 See paragraph (a) of new Rule 17g-8; see also Section II.F.1 of this release for a more detailed discussion of this proposal.

1365 See Section V.G.2 of this release for a more detailed discussion of the basis for these cost estimates.

1366 See proposed new paragraph (a) of Rule 17g-7 see also Sections II.G.1 through G.5 of this release for a more detailed discussion of this proposal.

approximately $15,237,500 and an industry-wide annual cost of approximately $115,580,930.[1367] Moreover, the Commission preliminarily estimates that the one-time and annual costs would vary considerably among NRSROs based on the number of credit ratings they issue and monitor and the number of classes and subclasses of credit ratings for which they issue and monitor credit ratings. Consequently, the Commission preliminarily estimates that the proposal would result in an average one-time cost to the small NRSRO of approximately $60,340 and an average annual cost to the small NRSRO of approximately $457,700.[1368]

As discussed above in Section V.K.2 of this release, the Commission preliminarily estimates that proposed new Rule 17g-9 would result in one-time and annual costs to each NRSRO.[1369] Based on the total number of credit rating analysts employed by the 10 NRSROs, the Commission preliminarily estimates an industry-wide one-time cost of approximately $5,363,000 and an industry-wide annual cost of approximately $1,072,720.[1370] Moreover, the Commission preliminarily estimates that these costs would be allocated to the 10 NRSROs based on the number of credit analysts each employs. Consequently, the Commission preliminarily estimates that the proposal would result in an average one-time cost to the small NRSRO of approximately $80,552 and an average annual cost to the small NRSRO of approximately $16,112.[1371]

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1367 See Section V.H.2 of this release for a more detailed discussion of the basis for these cost estimates.

1368 $15,237,500 x .00396 = $60,340.50, rounded to $60,340; $115,580,930 x .00396 = $457,700.48, rounded to $457,700.

1369 See proposed new Rule 17g-9; see also Section II.I.1 of this release for a more detailed discussion of this proposal.

1370 See Section V.K.2 of this release for a more detailed discussion of the basis for these cost estimates.

1371 $5,363,000 x .01502 = $80,552.26, rounded to $80,552; $1,072,720 x .01502 = $16,112.25, rounded to $16,112..

As discussed above in Section V.L.2 of this release, the Commission preliminarily estimates that paragraph (b) of proposed new Rule 17g-8 would result in one-time and annual costs to each NRSRO.[1372] In particular, the Commission preliminarily estimates that the proposal would result in an average one-time cost to each NRSRO of approximately $54,600 and an average annual cost to each NRSRO of approximately $13,650.[1373]

As discussed above in Section V.N.2 of this release, the Commission preliminarily estimates that proposed requirement to file certain Form NRSROs (and Exhibits 1 through 9) and the Rule 17g-3 annual reports with the Commission through the EDGAR system would result in one-time costs to each NRSRO.[1374] In particular, the Commission preliminarily estimates that the proposal would result in an average one-time cost to each NRSRO of approximately $1,365.[1375]

As discussed above in Sections V.A.2, V.C.2, V.G.2, V.K.2, and V.L.2 of this release, the Commission has proposed applying the recordkeeping requirements of Rule 17g-2 to five new types of records.[1376] The Commission preliminarily estimates that these proposals would result in one-time and annual costs to each NRSRO. In particular, the Commission preliminarily

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[1372] See paragraph (b) of proposed new Rule 17g-8; see also Section II.J.1 of this release for a more detailed discussion of this proposal.

[1373] See Section V.L.2 of this release for a more detailed discussion of the basis for these cost estimates.

[1374] See proposed amendments to Regulation S-T, Rule 17g-1, and Rule 17g-3; see also Section II.L of this release for a more detailed discussion of this proposal.

[1375] See Section V.N.2 of this release for a more detailed discussion of the basis for this cost estimate.

[1376] See proposed new paragraphs (a)(9), (b)(12), (b)(13), (b)(14), and (b)(15) of Rule 17g-2; see also Sections II.A.2, II.C.2, II.F.2, II.I.2, and II.J.2 of this release, respectively, for a more detailed discussion of these proposals.

estimates an average one-time cost to each NRSRO of approximately $5,460 and an average annual cost to each NRSRO of approximately $1,365.[1377]

Finally, as discussed in Section V.J.2 of this release, the Commission preliminarily estimates that proposed new Rule 17g-10 and proposed new Form ABS Due Diligence-15E would result in one-time and annual costs to providers of third-party due diligence services.[1378] In particular, the Commission estimates an average one-time cost to each provider of third-party due diligence services of approximately $91,425.[1379] In addition, the Commission preliminarily estimates that the annual cost resulting from these proposals would be based on the number of Exchange Act-ABS transactions issued per year. Consequently, the Commission preliminarily estimates that the industry-wide annual cost would be approximately $282,282.[1380] For this reason, the Commission preliminarily estimates that the average annual cost to each provider of third-party due diligence services would be approximately $28,228.[1381]

As noted above, the Commission preliminarily estimates that these costs largely are attributable to rulemaking mandates in the Dodd-Frank Act. The Commission also notes that the Dodd-Frank Act explicitly provides that the Commission's rulemaking make exceptions for small NRSROs in one instance.[1382] The Commission preliminary believes that the exercise of

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1377 $1,092 x 5 = $5,460; $273 x 5 = $1,365. See Sections V.A.2, V.C.2, V.G.2, V.K.2, and V.L.2 of this release for a more detailed discussion of the basis for these cost estimates.

1378 See proposed new Rule 17g-10 and proposed new Form ABS Due Diligence-15E; see also Sections II.H.2 and II.H.3 of this release, respectively, for a more detailed discussion of these proposals.

1379 See Section V.J.2 of this release for a more detailed discussion of the basis for this cost estimate.

1380 Id.

1381 $282,282/10 small providers of third-party due diligence services = $28,228.20 (rounded to $28,228).

1382 See Pub. L. No. 111-203 § 932(a)(4) and 15 U.S.C. 78o-7(h)(3)(B)(i).

the Commission's discretionary rulemaking would not disproportionately affect small entities. The Commission preliminarily believes that the exercise of discretionary rulemaking strikes an appropriate balance between minimizing the burden on small entities and meeting the rulemaking mandates in the Dodd-Frank Act.

### E. DUPLICATIVE, OVERLAPPING, OR CONFLICTING FEDERAL RULES

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed rules.

### F. SIGNIFICANT ALTERNATIVES

Pursuant to Section 3(a) of the RFA,[1383] the Commission must consider certain types of alternatives, including: (1) the establishment of differing compliance or recording requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rules for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the proposed rules, or any part of the proposed rules, for small entities.

The Commission preliminarily believes that the exercise of discretionary rulemaking with respect to the proposed amendments to existing rules and proposed new rules strike the appropriate balance between minimizing the burden on entities and allowing the Commission to meet its mandate under the Dodd-Frank Act. The Commission notes the Dodd-Frank Act explicitly mandated the Commission provide for exceptions for small NRSROs with respect to only one rulemaking and the Commission has proposed a rule amendment to implement this

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1383 5 U.S.C. 603(c).

provision.[1384] Consequently, the Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the proposed amendments to existing rules and proposed new rules for small entities; or summarily exempt small entities from coverage of the rule, or any part of the rule. The Commission believes that it is inconsistent with the goals of the Dodd-Frank Act to use performance standards rather than design standards. Further, the Commission believes that it would be inconsistent with the purposes of the Dodd-Frank Act to exempt small entities from compliance with the proposed rules.

### G. Request for Comment

The Commission generally requests comment on the certification and all aspects of its analysis in the IRFA. In addition, the Commission also seeks comment on the following:

1. Would the number of small entities that would be subject to the proposed requirements have any effects that have not been discussed?
2. Describe the nature of any effects on small entities subject to proposed requirements and provide empirical data to support the nature and extent of such effects.
3. Describe the compliance burdens and how they would affect small entities.

## VIII. STATUTORY AUTHORITY

The Commission is proposing amendments to §§ 232.101, 232.201, 232.314, 240.17g-1, 240.17g-2, 240.17g-3, 240.17g-5, 240.17g-6, 240.17g-7, Form NRSRO, and Form ABS-15G and is proposing to adopt §§ 240.15Ga-2, 240.17g-8, 240.17g-9, 240.17g-10, and Form ABS Due Diligence-15E pursuant to the authority conferred by the Exchange Act, including Sections 15E,

1384 See 15 U.S.C. 78o-7(h)(3)(B)(i) and proposed new paragraph (f) of Rule 17g-5; see also Section II.B.2 of this release for a more detailed discussion of this proposal.

17(a) and 36 (15 U.S.C. 78o–7, 78q, and 78mm), and pursuant to authority in Sections 936, 938, and 943 of the Dodd-Frank Act (Pub. L. No. 111-203 §§ 936, 938, and 943).

**List of Subjects in 17 CFR Parts 232, 240, 249, and 249b**

Brokers, Reporting and recordkeeping requirements, Securities.

**Text of Proposed Rules**

In accordance with the foregoing, the Commission proposes that Title 17, Chapter II of the Code of Federal Regulation be amended as follows.

**PART 232 – REGULATION S-T – GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS**

1. The authority citation for part 232 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77z-3, 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll, 80a-6(c), 80a-8, 80a-29, 80a-30, 80a-37, and 7201 et seq.; and 18 U.S.C. 1350.

* * * * *

2. Section 232.101 is amended by adding paragraph (a)(1)(xiv).

The addition reads as follows:

**§ 232.101 Mandated electronic submissions and exceptions.**

(a) * * *

(1) * * *

(xiv) Form NRSRO (§ 249b.300 of this chapter), and the information and documents in Exhibits 1 through 9 of Form NRSRO, filed with or furnished, as applicable, to the Commission pursuant to §§ 240.17g-1(e), (f), and (g) of this chapter and the annual reports filed with or furnished to, as applicable, the Commission pursuant to § 240.17g-3 of this chapter.

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3. Section 232.201 is amended by revising the introductory text to paragraph (a). The revision reads as follows:

**§ 232.201 Temporary hardship exemption.**

(a) If an electronic filer experiences unanticipated technical difficulties preventing the timely preparation and submission of an electronic filing other than a Form 3 (§249.103 of this chapter), a Form 4 (§ 249.104 of this chapter), a Form 5 (§ 249.105 of this chapter), a Form ID (§§ 239.63, 249.446, 269.7 and 274.402 of this chapter), a Form TA–1 (§ 249.100 of this chapter), a Form TA–2 (§249.102 of this chapter), a Form TA–W (§ 249.101 of this chapter), a Form D (§ 239.500 of this chapter), an application for an order under any section of the Investment Company Act (15 U.S.C. 80a–1 et seq.), an Interactive Data File (§ 232.11 of this chapter), or a Form NRSRO (§ 249b.300 of this chapter), and the information and documents in Exhibits 1 through 9 of Form NRSRO, filed with or furnished to, as applicable, the Commission pursuant to §§ 240.17g-1(e), (f), or (g) of this chapter, or the annual reports filed with or furnished to, as applicable, the Commission pursuant to § 240.17g-3 of this chapter, the electronic filer may file the subject filing, under cover of Form TH (§§ 239.65, 249.447, 269.10 and 274.404 of this chapter), in paper format no later than one business day after the date on which the filing was to be made.

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4. Section 232.314 is amended by:

a. In the introductory text inserting the phrase "or in response to Rule 15Ga-2 (§ 240.15Ga-2 of this chapter)" after the phrase "The information required in response to Rule 15Ga-1 (§ 240.15Ga-1 of this chapter)";

b. In paragraph (a), removing the words "Securities Exchange Act of 1934" and in their place inserting the word "Act"; and

c. In paragraph (b):

i. Inserting the words "or Rule 15Ga-2" after the phrase "The information required by Rule 15Ga-1"; and

ii. Removing the words "Web site" and in their place inserting the word "website".

**PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

5. The authority citation for part 240 is amended by adding sectional authorities for §§ 240.15Ga-2, 240.17g-8, and 240.17g-9 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, 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.

* * * * *

Section 240.15Ga-2 is also issued under sec. 943, Pub. L. No. 111-203, 124 Stat. 1376.

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Section 240.17g-8 is also issued under sec. 938, Pub. L. No. 111-203, 124 Stat. 1376.

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Section 240.17g-9 is also issued under sec. 936, Pub. L. No. 111-203, 124 Stat. 1376.

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6. Section 240.15Ga-2 is added to read as follows:

**§ 240.15Ga-2 Findings and conclusions of third-party due diligence reports.**

(a) The issuer or underwriter of an offering of any asset-backed security (as that term is defined in Section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) shall furnish Form ABS-15G (§ 249.1400 of this chapter) if the security is to be rated by a nationally recognized statistical rating organization, containing the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter five business days prior to the first sale in the offering; however, if the issuer or underwriter receives a representation from a nationally recognized statistical rating organization that can be reasonably relied upon that the disclosure required by this paragraph will be publicly disclosed by the nationally recognized statistical rating organization five business days prior to the first sale in the offering in an information disclosure form generated pursuant to Rule 17g-7(a)(1) (§ 240.17g-7(a)(1) of this chapter) and included with the credit rating, the issuer or underwriter would not be required to furnish Form ABS-15G five days prior to the first sale in the offering.

(b) If the issuer or underwriter receives a representation pursuant to paragraph (a) of this section, but the nationally recognized statistical rating organization has not fulfilled its representation to publicly disclose the disclosure five business days prior to the first sale in the offering, the issuer or underwriter shall furnish Form ABS-15G two business days prior to the first sale in the offering.

(c) For purposes of paragraph (a) of this section, "third-party due diligence report" means any report containing findings and conclusions of any "due diligence services" as defined in Rule 17g-10(c)(1) (§ 240.17g-10(c)(1) of this chapter) performed by a third party.

Instruction to paragraph (a) of this section: The issuer or underwriter shall provide to the Commission, upon request, information regarding the manner in which the representation by the nationally recognized statistical rating organization was obtained and relied upon for purposes of this paragraph.

7. Section 240.17g-1 is amended by:

a. In paragraphs (a), (b), and (c) removing the phase "furnish the Commission with" and its place inserting the phrase "file with the Commission two paper copies of";

b. In paragraph (d), inserting the phrase "two paper copies of" after the phrase "the applicant must furnish the Commission with"; and

c. Revising paragraphs (e), (f), (g), (h), and (i).

The revisions read as follows:

**§ 240.17g-1 Application for registration as a nationally recognized statistical rating organization.**

* * * * *

(e) Update of registration. A nationally recognized statistical rating organization amending materially inaccurate information in its application for registration pursuant to section 15E(b)(1) of the Act (15 U.S.C. 78o-7(b)(1)) must promptly file with the Commission an update of its registration on Form NRSRO that follows all applicable instructions for the Form. A Form NRSRO and the information and documents in Exhibits 1 through 9 of Form NRSRO filed under this paragraph must be filed electronically with the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.

(f) Annual certification. A nationally recognized statistical rating organization amending its application for registration pursuant to section 15E(b)(2) of the Act (15 U.S.C. 78o-7(b)(2)) must file with the Commission an annual certification on Form NRSRO that follows all applicable instructions for the Form not later than 90 days after the end of each calendar year. A Form NRSRO and the information and documents in Exhibits 1 through 9 of Form NRSRO filed under this paragraph must be filed electronically with the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.

(g) Withdrawal from registration. A nationally recognized statistical rating organization withdrawing from registration pursuant to section 15E(e)(1) of the Act (15 U.S.C. 78o-7(e)(1)) must furnish the Commission with a notice of withdrawal from registration on Form NRSRO that follows all applicable instructions for the Form. The withdrawal from registration will become effective 45 calendar days after the notice is furnished to the Commission upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors. A Form NRSRO furnished under this paragraph must be furnished electronically with the Commission in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.

(h) Filing or furnishing Form NRSRO. A Form NRSRO filed or furnished, as applicable, under any paragraph of this section will be considered filed with or furnished to, as applicable, the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the Form. Information filed or furnished, as applicable, on a confidential basis and for which confidential treatment has been requested pursuant to applicable Commission rules will be accorded confidential treatment to the extent permitted by law.

(i) Public availability of Form NRSRO. A nationally recognized statistical rating organization must make its current Form NRSRO and information and documents in Exhibits 1 through 9 to Form NRSRO publicly and freely available on an easily accessible portion of its corporate Internet website within 10 business days after the date of the Commission order granting an initial application for registration as a nationally recognized statistical rating organization or an application to register for an additional class of credit ratings and within 10 business days after filing with or furnishing to, as applicable, the Commission a Form NRSRO under paragraphs (e), (f), or (g) of this section. In addition, a nationally recognized statistical rating organization must make its up-to-date Exhibit 1 to Form NRSRO freely available in writing to any individual who requests a copy of the Exhibit.

8. Section 240.17g-2 is amended by:

a. In paragraphs (a)(2)(iii) and (a)(7), removing the words "or mortgage-backed";

b. Adding paragraph (a)(9);

c. Revising paragraph (b)(1);

d. In paragraph (b)(9), removing the words "or mortgage-backed";

e. Revising paragraph (b)(11);

f. Adding paragraphs (b)(12), (b)(13), (b)(14), and (b)(15);

g. Re-designating paragraph (d)(1) as paragraph (d); and

h. Removing paragraphs (d)(2) and (d)(3);

The additions and revisions read as follows:

**§240.17g-2 Records to be made and retained by nationally recognized statistical rating organizations.**

(a) * * *

(9) A record documenting the policies and procedures the nationally recognized statistical rating organization is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Act (15 U.S.C. 78o-7(h)(4)(A)) and § 240.17g-8(c) of this chapter.

* * * * *

(b) * * *

(1) Significant records (for example, bank statements, invoices, and trial balances) underlying the information included in the annual financial reports the nationally recognized statistical rating organization files with or furnishes to, as applicable, the Commission pursuant to § 240.17g-3 of this chapter.

* * * * *

(11) Form NRSROs (including Exhibits and accompanying information and documents) the nationally recognized statistical rating organization files with or furnishes to, as applicable, the Commission.

(12) The internal control structure the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to Section 15E(c)(3)(A) of the Act (15 U.S.C. 78o-7(c)(3)(A)).

(13) The policies and procedures the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to §240.17g-8(a) of this chapter.

(14) The policies and procedures the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to §240.17g-8(b) of this chapter.

(15) The standards of training, experience, and competence for credit analysts the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to §240.17g-9 of this chapter.

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9. Section 240.17g–3 is amended by:

a. Revising the heading;

b. Revising the introductory text of paragraph (a);

c. In paragraph (a)(1), removing the first word "Audited" and in its place inserting the phrase "File with the Commission a financial report, as of the end of the fiscal year, containing audited";

d. In paragraph (a)(2), removing the first word "If" and in its place inserting the phrase "File with the Commission a financial report, as of the end of the fiscal year, containing, if";

e. In the Note to paragraph (a)(2), removing the word "furnished" and in its place inserting the word "filed";

f. In paragraphs (a)(3), (a)(4), and (a)(5), removing the first word "An" and in its place inserting the phrase "File with the Commission an unaudited financial report, as of the end of the fiscal year,";

g. In paragraph (a)(6), removing the first word "An" and in its place inserting the phrase "Furnish the Commission with an unaudited report, as of the end of the fiscal year,";

h. In the Note to paragraph (a)(6), removing the words "or mortgage-backed";

i. Adding paragraphs (a)(7) and (a)(8);

j. Revising paragraph (b) and re-designating paragraph (b) as paragraph (b)(1);

k. Adding paragraphs (b)(2), (d), and (e).

The additions and revisions read as follows:

**§ 240.17g-3 Annual financial and other reports to be filed or furnished by nationally recognized statistical rating organizations.**

(a) A nationally recognized statistical rating organization must annually, not more than 90 calendar days after the end of its fiscal year (as indicated on its current Form NRSRO):

* * * * *

(7) File with the Commission an unaudited report, as of the end of the fiscal year, concerning the internal control structure the nationally recognized statistical rating organization is required to establish, maintain, enforce, and document pursuant to Section 15E(c)(3)(A) of the Act (15 U.S.C. 78o-7(c)(3)(A)) that contains:

(i) A description of the responsibility of management in establishing and maintaining an effective internal control structure; and

(ii) An assessment by management of the effectiveness of the internal control structure.

(8) File with the Commission an unaudited annual report on the compliance of the nationally recognized statistical rating organization with the securities laws and the policies and procedures of the nationally recognized statistical rating organization pursuant to Section 15E(j)(5)(B) of the Act (15 U.S.C. 78o-7(j)(5)(B)).

(b) The nationally recognized statistical rating organization must:

(1) Attach to the reports filed or furnished, as applicable, pursuant to paragraphs (a)(1) through (a)(6) of this section a signed statement by a duly authorized person associated with the nationally recognized statistical rating organization stating that the person has responsibility for the reports and, to the best knowledge of the person, the reports fairly present, in all material respects, the financial condition, results of operations, cash flows, revenues, analyst compensation, and credit rating actions of the nationally recognized statistical rating organization for the period presented; and

(2) Attach to the report filed pursuant to paragraph (a)(7) of this section a signed statement by the chief executive officer of the nationally recognized statistical rating organization or, if the nationally recognized statistical rating organization does not have a chief executive officer, an individual performing similar functions, stating that the chief executive

officer or individual has responsibility for the report and, to the best knowledge of the chief executive officer or other individual, the report fairly presents, in all material respects, a description of the responsibility of management in establishing and maintaining an effective internal control structure and an assessment of the effectiveness of the internal control structure.

* * * * *

(d) Electronic Filing. The reports must be filed with or furnished to, as applicable, the Commission electronically in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T.

(e) Confidential Treatment. Information in a report filed or furnished, as applicable, on a confidential basis and for which confidential treatment has been requested pursuant to applicable Commission rules will be accorded confidential treatment to the extent permitted by law. Confidential treatment may be requested by marking each page "Confidential Treatment Requested" and by complying with Commission rules governing confidential treatment.

10. Section 240.17g-5 is amended by:

a. In paragraph (a)(3), removing the words "or mortgaged-backed";

b. In paragraphs (a)(3)(i), (a)(3)(ii), (a)(3)(iii)(A), (a)(3)(iii)(B), (a)(3)(iii)(C), and (a)(3)(iii)(D), removing the words "Web site" and in their place inserting the word "website";

c. In paragraph (b)(9), removing the words "or mortgaged-backed";

d. In paragraph (c)(6), removing the word "or" at the end of the paragraph after the ";";

e. In paragraph (c)(7), inserting the word "or" at the end of the paragraph after the ";";

f. Adding paragraph (c)(8);

g. In paragraph (e), removing the words "Web site" and in their place inserting the word "website" and removing the words "Web sites" and in their place inserting the word "websites"; and

h. Adding paragraphs (f) and (g).

The additions read as follows:

**§ 240.17g-5 Conflicts of interest.**

* * * * *

(c) * * *

* * * * *

(8) The nationally recognized statistical rating organization issues or maintains a credit rating where a person within the nationally recognized statistical rating organization who participates in sales or marketing of a product or service of the nationally recognized statistical rating organization or a product or service of a person associated with the nationally recognized statistical rating organization also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.

* * * * *

(f) Upon written application by a nationally recognized statistical rating organization, the Commission may exempt, either conditionally or unconditionally or on specified terms and conditions, such nationally recognized statistical rating organization from the provisions of paragraph (c)(8) of this section if the Commission finds that due to the small size of the nationally recognized statistical rating organization it is not appropriate to require the separation within the nationally recognized statistical rating organization of the production of credit ratings from sales and marketing activities and such exemption is in the public interest.

(g) In a proceeding pursuant to Section 15E(d) of the Act (15 U.S.C. 78o-7(d)) or Section 21C of the Act (15 U.S.C. 78u-3), the Commission shall suspend or revoke the registration of a nationally recognized statistical rating organization if the Commission finds in such proceeding that the nationally recognized statistical rating organization has violated a rule issued under Section 15E(h) of the Act (15 U.S.C. 78o-7(h)), that the violation affected a rating, and that suspension or revocation is necessary for the protection of investors and in the public interest.

11. Section 240.17g-6 is amended by, in paragraph (a)(4), removing the words "or mortgage-backed".

12. Section 240.17g-7 is amended by removing the introductory text and revising the heading, paragraphs (a) and (b), and the Note.

These revisions to read as follows:

**§240.17g-7 Disclosure requirements.**

(a) Disclosures to be made when taking a rating action. A nationally recognized statistical rating organization must publish the items described in paragraphs (a)(1) and (a)(2) of this section, as applicable, when taking a rating action with respect to a credit rating assigned to an obligor, security, or money market instrument in a class of credit ratings for which the nationally recognized statistical rating organization is registered. For purposes of this section, the term "rating action" means any of the following: the publication of an expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating; an initial credit rating; an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default); a placement of an existing credit rating on credit watch or review; an affirmation of an existing credit rating; and a withdrawal of an existing credit rating. The items described in paragraphs (a)(1) and (a)(2) of this section must be published in the same medium and made available to the same persons who can receive or access the credit rating that is the result of the rating action or that is the subject of the rating action.

(1) Information disclosure form. A form generated by the nationally recognized statistical rating organization that meets the requirements of paragraphs (a)(1)(i), (a)(1)(ii), and (a)(1)(iii) of this section.

(i) Format. The form generated by the nationally recognized statistical rating organization must be in a format that:

(A) Is easy to use and helpful for users of credit ratings to understand the information contained in the form; and

(B) Provides the content described in paragraphs (a)(1)(ii)(K), (L), and (M) of this section in a manner that is directly comparable across types of obligors, securities, and money market instruments.

(ii) Content. The form generated by the nationally recognized statistical rating organization must contain the following information about the credit rating:

(A) The symbol, number, or score in the rating scale used by the nationally recognized statistical rating organization to denote credit rating categories and notches within categories assigned to the obligor, security, or money market instrument that is the subject of the credit rating and the identity of the obligor, security, or money market instrument;

(B) The version of the procedure or methodology used to determine the credit rating;

(C) The main assumptions and principles used in constructing the procedures and methodologies used to determine the credit rating, including qualitative methodologies and quantitative inputs and, if the credit rating is for a structured finance product, assumptions about the correlation of defaults across the underlying assets;

(D) The potential limitations of the credit rating, including the types of risks excluded from the credit rating that the nationally recognized statistical rating organization does not comment on, including, as applicable, liquidity, market, and other risks;

(E) Information on the uncertainty of the credit rating, including:

(1) Information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and

(2) A statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including:

(i) Any limits on the scope of historical data; and

(ii) Any limits on accessibility to certain documents or other types of information that would have better informed the credit rating;

(F) Whether and to what extent third-party due diligence services were used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party;

(G) If applicable, how servicer or remittance reports were used, and with what frequency, to conduct surveillance of the credit rating;

(H) A description of the data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating;

(I) A statement containing an overall assessment of the quality of information available and considered in determining the credit rating for the obligor, security, or money market instrument, in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar obligors, securities, or money market instruments;

(J) Information relating to conflicts of interest of the nationally recognized statistical rating organization, which must include:

(1) A classification of the credit rating as either:

(i) "Solicited sell-side," meaning the credit rating was paid for by the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated;

(ii) "Solicited buy-side," meaning the credit rating was paid for by a person other than the obligor being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated; or

(iii) "Unsolicited," meaning the nationally recognized statistical rating organization was not paid to determine the credit rating;

(2) If the credit rating is classified as either "solicited sell-side" or "solicited buy-side" under paragraph (a)(1)(ii)(J)(*1*) of this section, disclosure of whether the nationally recognized statistical rating organization provided services other than determining credit ratings to the person that paid for the rating during the most recently ended fiscal year; and

(3) If the rating action results from a review conducted pursuant to Section 15E(h)(4)(A) of the Act (15 U.S.C. 78o-7(h)(4)(A)) and §240.17g-8(c) of this chapter, provide the following information (as applicable):

(i) If the rating action is a placement of the credit rating on credit watch pursuant to §240.17g-8(c)(1) of this chapter, an explanation that the reason for the action is the discovery that a credit rating assigned to the obligor, security, or money market instrument in one or more prior rating actions was influenced by a conflict of interest and the date and associated credit rating of each prior rating action that the nationally recognized statistical rating organization currently has determined was influenced by the conflict;

(ii) If the rating action is a revision of the credit rating pursuant to §240.17g-8(c)(3)(i) of this chapter, an explanation that the reason for the action is the discovery that a credit rating assigned to the obligor, security, or money market instrument in one or more prior rating actions was influenced by a conflict of interest, the date and associated credit rating of each prior rating action the nationally recognized statistical rating organization has determined was influenced by the conflict, and an estimate of the impact the conflict had on each such prior rating action;

(iii) If the rating action is an affirmation of the credit rating pursuant to §240.17g-8(c)(3)(ii) of this chapter, an explanation of why no rating action was taken to revise the credit rating notwithstanding the conflict, the date and associated credit rating of each prior rating action the nationally recognized statistical rating organization has determined was influenced by the conflict, and an estimate of the impact the conflict had on each such prior rating action.

(K) An explanation or measure of the potential volatility of the credit rating, including:

(1) Any factors that might lead to a change in the credit rating; and

(2) The magnitude of the change that could occur under different market conditions;

(L) Information on the content of the credit rating, including:

(1) If applicable, the historical performance of the credit rating; and

(2) The expected probability of default and the expected loss in the event of default;

(M) Information on the sensitivity of the credit rating to assumptions made by the nationally recognized statistical rating organization, including:

(1) Five assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and

(2) An analysis, using specific examples, of how each of the five assumptions identified in paragraph (a)(1)(ii)(M)(*1*) of this section impacts a rating;

(N) If the credit rating is issued with respect to an asset-backed security, as defined in Section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), a description of:

(1) The representations, warranties, and enforcement mechanisms available to investors; and

(2) How they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities.

(iii) Attestation. The nationally recognized statistical rating organization must attach to the form a signed statement by a person within the nationally recognized statistical rating organization stating that the person has responsibility for the rating action and, to the best knowledge of the person:

(A) No part of the credit rating was influenced by any other business activities;

(B) The credit rating was based solely upon the merits of the obligor, security, or money market instrument being rated; and

(C) The credit rating was an independent evaluation of the risks and merits of the obligor, security, or money market instrument.

(2) Third-party due diligence certification. Any written certification related to the credit rating received by the nationally recognized statistical rating organization from a provider of third-party due diligence services pursuant to Section 15E(s)(4)(B) of the Act (15 U.S.C. 78o-7(s)(4)(B)).

(b) Disclosure of credit rating histories.

(1) Credit ratings subject to the disclosure requirement. A nationally recognized statistical rating organization must publicly disclose for free on an easily accessible portion of its corporate Internet website:

(i) Each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the nationally recognized statistical rating organization is registered that was outstanding as of June 26, 2007 and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on credit watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument; and

(ii) Each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the nationally recognized statistical rating organization is registered that was initially determined on or after June 26, 2007 and any subsequent upgrades or downgrades of a credit rating assigned to the obligor, security, or money market instrument (including a downgrade to, or assignment of, default), any placements of a credit rating assigned to the obligor, security, or money market instrument on credit watch or review, any affirmation of a credit rating assigned to the obligor, security, or money market instrument, and a withdrawal of a credit rating assigned to the obligor, security, or money market instrument.

(2) Information. A nationally recognized statistical rating organization must include, at a minimum, the following information with each credit rating disclosed pursuant to paragraph (b)(1) of this section:

(i) The identity of the nationally recognized statistical rating organization disclosing the rating action;

(ii) The date of the rating action;

(iii) If the rating action is taken with respect to a credit rating of an obligor as an entity, the following identifying information about the obligor, as applicable:

(A) The Central Index Key (CIK) number of the rated obligor; and

(B) The legal name of the obligor.

(iv) If the rating action is taken with respect to a credit rating of a security or money market instrument, as applicable:

(A) The Central Index Key (CIK) number of the issuer of the security or money market instrument;

(B) The legal name of the issuer of the security or money market instrument; and

(C) The CUSIP of the security or money market instrument;

(v) A classification of the rating action as either:

(A) A disclosure of a credit rating that was outstanding as of June 26, 2007 for the purposes of paragraph (b)(1)(i) of this section;

(B) An initial credit rating;

(C) An upgrade of an existing credit rating;

(D) A downgrade of an existing credit rating, which would include classifying the obligor, security, or money market instrument as in default, if applicable;

(E) A placement of an existing credit rating on credit watch or review;

(F) An affirmation of an existing credit rating; or

(G) A withdrawal of an existing credit rating and, if the classification is withdrawal, the nationally recognized statistical rating organization also must classify the reason for the withdrawal as either:

(1) The obligor defaulted, or the security or money market instrument went into default;

(2) The obligation subject to the credit rating was extinguished by payment in full of all outstanding principal and interest due on the obligation according to the terms of the obligation; or

(3) The credit rating was withdrawn for reasons other than those set forth in paragraph (b)(2)(v)(G)(1) or (2) of this section; and

(vi) The classification of the class or subclass that applies to the credit rating as either:

(A) Financial institutions, brokers, or dealers;

(B) Insurance companies;

(C) Corporate issuers; or

(D) Issuers of structured finance products in one of the following subclasses:

(1) Residential mortgage backed securities ("RMBS") (for purposes of this subclass, RMBS means a securitization primarily of residential mortgages);

(2) Commercial mortgage backed securities ("CMBS") (for purposes of this subclass, CMBS means a securitization primarily of commercial mortgages);

(3) Collateralized loan obligations ("CLOs") (for purposes of this subclass, a CLO means a securitization primarily of commercial loans);

(4) Collateralized debt obligations ("CDOs) (for purposes of this subclass, a CDO means a securitization primarily of other debt instruments such as RMBS, CMBS, CLOs, CDOs, other asset backed securities, and corporate bonds);

(5) Asset-backed commercial paper conduits ("ABCP") (for purposes of this subclass, ABCP means short term notes issued by a structure that securitizes a variety of financial assets, such as trade receivables or credit card receivables, which secure the notes);

(6) Other asset-backed securities ("other ABS") (for purposes of this subclass, other ABS means a securitization primarily of auto loans, auto leases, floor plans, credit card receivables, student loans, consumer loans, or equipment leases); or

(7) Other structured finance products ("other SFPs") (for purposes of this subclass, other SFPs means any structured finance product not identified in paragraphs (b)(2)(iv)(D)(1) through (6)) of this section; or

(E) Issuers of government securities, municipal securities, or securities issued by a foreign government in one of the following subclasses:

(1) Sovereign issuers;

(2) United States public finance; or

(3) International public finance; and

(vii) The credit rating symbol, number, or score in the applicable rating scale of the nationally recognized statistical rating organization assigned to the obligor, security, or money market instrument as a result of the rating action or, if the credit rating remained unchanged as a result of the rating action, the credit rating symbol, number, or score in the applicable rating scale of the nationally recognized statistical rating organization assigned to the obligor, security, or money market instrument as of the date of the rating action (in either case, include a credit rating in a default category, if applicable).

(3) Format. The information identified in paragraph (b)(2) of this section must be disclosed in an interactive data file that uses an XBRL (eXtensible Business Reporting Language) format and the List of XBRL Tags for NRSROs as published on the Internet website of the Commission.

(4) Timing. The nationally recognized statistical rating organization must disclose the information required in paragraph (b)(2) of this section:

(i) Within twelve months from the date the rating action is taken, if the credit rating subject to the action was paid for by the obligor being rated or by the issuer, underwriter, depositor, or sponsor of the security being rated; or

(ii) Within twenty-four months from the date the rating action is taken, if the credit rating subject to the action is not a credit rating described in paragraph (b)(4)(i) of this section.

(5) Removal of a credit rating history. The nationally recognized statistical rating organization may cease disclosing a rating history of an obligor, security, or money market instrument no earlier than 20 years after the date a rating action with respect to the obligor, security, or money market instrument is classified as a withdrawal of the credit rating pursuant to paragraph (b)(2)(v)(G) of this section, provided that no subsequent credit ratings are assigned to the obligor, security, or money market instrument after the withdrawal classification.

13. Section 240.17g-8 is added to read as follows:

**§240.17g-8 Policies and procedures.**

(a) Policies and procedures with respect to the procedures and methodologies used to determine credit ratings. A nationally recognized statistical rating organization must establish, maintain, enforce, and document policies and procedures reasonably designed to ensure:

(1) That the procedures and methodologies, including qualitative and quantitative data and models, the nationally recognized statistical rating organization uses to determine credit ratings are approved by its board of directors or a body performing a function similar to that of a board of directors.

(2) That the procedures and methodologies, including qualitative and quantitative data and models, the nationally recognized statistical rating organization uses to determine credit ratings are developed and modified in accordance with the policies and procedures of the nationally recognized statistical rating organization.

(3) That material changes to the procedures and methodologies, including changes to qualitative and quantitative data and models, the nationally recognized statistical rating organization uses to determine credit ratings are:

(i) Applied consistently to all credit ratings to which the changed procedures or methodologies apply; and

(ii) To the extent that the changes are to surveillance or monitoring procedures and methodologies, applied to then-current credit ratings within a reasonable period of time, taking into consideration the number of ratings impacted, the complexity of the procedures and methodologies used to determine the credit ratings, and the type of obligor, security, or money market instrument being rated.

(4) That the nationally recognized statistical rating organization promptly publishes on an easily accessible portion of its corporate Internet website:

(i) Material changes to the procedures and methodologies, including to qualitative models or quantitative inputs, the nationally recognized statistical rating organization uses to determine credit ratings, the reason for the changes, and the likelihood the changes will result in changes to any current ratings; and

(ii) Significant errors identified in a procedure or methodology, including a qualitative or quantitative model, the nationally recognized statistical rating organization uses to determine credit ratings that may result in a change in current credit ratings.

(5) That the nationally recognized statistical rating organization discloses the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.

(b) <u>Policies and procedures with respect to credit rating symbols, numbers, or scores</u>. A nationally recognized statistical rating organization must establish, maintain, enforce, and document policies and procedures that are reasonably designed to:

(1) Assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument.

(2) Clearly define each symbol, number, or score in the rating scale used by the nationally recognized statistical rating organization to denote a credit rating category and notches within a category for each class and subclass of credit ratings for which the nationally recognized statistical rating organization is registered and to include such definitions in Exhibit 1 to Form NRSRO (§240b.300 of this chapter).

(3) Apply any symbol, number, or score defined pursuant to paragraph (b)(2) of this section in a manner that is consistent for all types of obligors, securities, and money market instruments for which the symbol, number, or score is used.

(c) Policies and procedures with respect to look-back reviews. The policies and procedures a nationally recognized statistical rating organization is required to establish, maintain, and enforce pursuant to Section 15E(h)(4)(A) of the Act (15 U.S.C. 78o-7(h)(4)(A)) must address instances in which a review conducted pursuant to those policies and procedures determines that a conflict of interest influenced a credit rating assigned to an obligor, security, or money market instrument by including, at a minimum, procedures that are reasonably designed to ensure that the nationally recognized statistical rating organization will:

(1) Immediately publish a rating action placing the applicable credit ratings of the obligor, security, or money market instrument on credit watch or review based on the discovery of the conflict and include with the publication of the rating action the information required by §240.17g-7(a)(1)(ii)(J)(3)(i) of this chapter;

(2) Promptly determine whether the current credit rating assigned to the obligor, security, or money market instrument must be revised so that it no longer is influenced by a conflict of interest and is solely a product of the documented procedures and methodologies the nationally recognized statistical rating organization uses to determine credit ratings; and

(3) Promptly publish, based on the determination of whether the current credit rating assigned to the obligor, security, or money market instrument must be revised (as applicable):

(i) A revised credit rating, if appropriate, and include with the publication of the revised credit rating the information required by §240.17g-7(a)(1)(ii)(J)(3)(ii) of this chapter; or

(ii) An affirmation of the credit rating, if appropriate, and include with the publication of the affirmation the information required by §240.17g-7(a)(1)(ii)(J)(3)(iii) of this chapter.

14. Section 240.17g-9 is added to read as follows:

**§240.17g-9 Standards of training, experience, and competence for credit analysts.**

(a) A nationally recognized statistical rating organization must establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to determine credit ratings that are reasonably designed to achieve the objective that such individuals produce accurate credit ratings in the classes and subclasses of credit ratings for which the nationally recognized statistical rating organization is registered.

(b) The nationally recognized statistical rating organization must consider the following when establishing the standards required under paragraph (a) of this section:

(1) If the credit rating procedures and methodologies used by the individual involve qualitative analysis, the knowledge necessary to effectively evaluate and process the data relevant to the creditworthiness of the obligor being rated or the issuer of the securities or money market instruments being rated;

(2) If the credit rating procedures and methodologies used by the individual involve quantitative analysis, the technical expertise necessary to understand any models and model inputs that are a part of the procedures and methodologies;

(3) The classes and subclasses of credit ratings for which the individual participates in determining credit ratings and the factors relevant to such classes and subclasses, including the geographic location, sector, industry, regulatory and legal framework, and underlying assets, applicable to the obligors or issuers in the classes and subclasses; and

(4) The complexity of the obligors, securities, or money market instruments being rated by the individual.

(c) The nationally recognized statistical rating organization must include the following in the standards required under paragraph (a) of this section:

(1) A requirement for periodic testing of the individuals employed by the nationally recognized statistical rating organization to determine credit ratings on their knowledge of the procedures and methodologies used by the nationally recognized statistical rating organization to determine credit ratings in the classes and subclasses of credit ratings for which the individual participates in determining credit ratings; and

(2) A requirement that at least one individual with three years or more experience in performing credit analysis participates in the determination of a credit rating.

15. Section 240.17g-10 is added to read as follows:

**§240.17g-10 Certification of providers of third-party due diligence services in connection with asset-backed securities.**

(a) The written certification that a person employed to provide third-party due diligence services is required to provide to a nationally recognized statistical rating organization pursuant to Section 15E(s)(4)(B) of the Act (15 U.S.C. 78o-7(s)(4)(B)) must be on Form ABS Due Diligence-15E (§240b.400 of this chapter).

(b) The written certification must be signed by an individual who is duly authorized by the person providing the third-party due diligence services to make such a certification.

(c) For the purposes of Section 15E(s)(4)(B) of the Act (15 U.S.C. 78o-7(s)(4)(B)) and this section:

(1) The term due diligence services means a review of the assets underlying an asset-backed security, as defined in Section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) for the purpose of making findings with respect to:

(i) The quality or integrity of the information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets;

(ii) Whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria, or other requirements;

(iii) The value of collateral securing such assets;

(iv) Whether the originator of the assets complied with federal, state, or local laws or regulations; or

(v) Any other factor or characteristic of such assets that would be material to the likelihood that the issuer of the asset-backed security will pay interest and principal according to its terms and conditions.

(2) 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, as defined in Section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)).

(3) The term originator has the same meaning as in Section 15G of the Act (15 U.S.C. 78o-9).

(4) The term securitizer has the same meaning as in Section 15G of the Act (15 U.S.C. 78o-9).

**PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934**

16. The authority citation for Part 249 continues to read as follows: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

17. Subpart O and Form ABS-15G (referenced in §249.1400) to Part 249 are amended to read as follows:

**Subpart O – Forms for Securitizers of Asset-Backed Securities**

**§249.1400 Form ABS-15G, Asset-backed securitizer report pursuant to Section 15G of the Securities Exchange Act of 1934**

This form shall be used for reports of information required by Rule 15Ga-1 (§240.15Ga-1 of this chapter) and Rule 15Ga-2 (§240.15Ga-2 of this chapter).

**Note: The text of Form ABS-15G does not, and this amendment will not, appear in the Code of Federal Regulations.**

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

**FORM ABS-15G**

**ASSET-BACKED SECURITIZER
REPORT PURSUANT TO SECTION 15G OF
THE SECURITIES EXCHANGE ACT OF 1934**

Check the appropriate box to indicate the filing obligation which this form is intended to satisfy:

____ Rule 15Ga-1 under the Exchange Act (17 CFR 240.15Ga-1) for the reporting period ________________ to ________________

____ Rule 15Ga-2 under the Exchange Act (17 CFR 240.15Ga-2)

Date of Report (Date of earliest event reported)______________________

Commission File Number of securitizer: ____________________

Central Index Key Number of securitizer: __________________

______________________________________________________________________

Name and telephone number, including area code, of the person to contact in connection with this filing

Indicate by check mark whether the securitizer has no activity to report for the initial period pursuant to Rule 15Ga-1(c)(1) [ ]

Indicate by check mark whether the securitizer has no activity to report for the quarterly period pursuant to Rule 15Ga-1(c)(2)(i) [ ]

Indicate by check mark whether the securitizer has no activity to report for the annual period pursuant to Rule 15Ga-1(c)(2)(ii) [ ]

____ For forms furnished pursuant to Rule 15Ga-2 under the Exchange Act (17 CFR 240.15Ga-2), also provide the following information:

Commission File Number of depositor: ______________________________

Central Index Key Number of depositor: ______________________________

______________________________
(Exact name of issuing entity as specified in its charter)

Central Index Key Number of issuing entity (if applicable): ____________

Commission File Number of issuing entity (if applicable): ____________

Commission File Number of underwriter (if applicable): ____________

Central Index Key Number of underwriter (if applicable): ____________

## GENERAL INSTRUCTIONS

**A. Rule as to Use of Form ABS-15G.**

This form shall be used to comply with the requirements of Rule 15Ga-1 (17 CFR 240.15Ga-1) and Rule 15Ga-2 (17 CFR 240.15Ga-2) under the Exchange Act.

**B. Events to be Reported and Time for Filing of Reports.**

Forms filed under Rule 15Ga-1. In accordance with Rule 15Ga-1, file the information required by Part I in accordance with Item 1.01, Item 1.02, or Item 1.03, as applicable. If the filing deadline for the information occurs on a Saturday, Sunday, or holiday on which the Commission is not open for business, then the filing deadline shall be the first business day thereafter.

Forms filed under Rule 15Ga-2. In accordance with Rule 15Ga-2, furnish the information required by Part II no later than five business days prior to the first sale of securities in the offering.

**C. Preparation of Report.**

This form is not to be used as a blank form to be filled in, but only as a guide in the preparation of the report on paper meeting the requirements of Rule 12b-12 (17 CFR 240.12b-12). The report shall contain the number and caption of the applicable item, but the text of such item may be omitted, provided the answers thereto are prepared in the manner specified in Rule 12b-13 (17 CFR 240.12b-13). All items that are not required to be answered in a particular report may be omitted and no reference thereto need be made in the report. All instructions should also be omitted.

**D. Signature and Filing of Report.**

1. Forms filed under Rule 15Ga-1. Any form filed for the purpose of meeting the requirements in Rule 15Ga-1 must be signed by the senior officer in charge of securitization of the securitizer.
2. Forms filed under Rule 15Ga-2. Any form filed for the purpose of meeting the requirements in Rule 15Ga-2 must be signed by the senior officer in charge of securitization of the depositor if information required by Item 2.01 is required to be provided and must be signed by a duly authorized officer of the underwriter if information required by Item 2.02 is required to be provided.
3. Copies of report. If paper filing is permitted, three complete copies of the report shall be filed with the Commission.

## INFORMATION TO BE INCLUDED IN THE REPORT

### PART I: REPRESENTATION AND WARRANTY INFORMATION

**Item 1.01 Initial Filing of Rule 15Ga-1 Representations and Warranties Disclosure**

Provide the disclosures required by Rule 15Ga-1 (17 CFR 240.15Ga-1) according to the filing requirements of Rule 15Ga-1(c)(1).

**Item 1.02 Periodic Filing of Rule 15Ga-1 Representations and Warranties Disclosure**

Provide the disclosures required by Rule 15Ga-1 (17 CFR 240.15Ga-1) according to the filing requirements of Rule 15Ga-1(c)(2).

**Item 1.03 Notice of Termination of Duty to File Reports under Rule 15Ga-1**

If a securitizer terminates its reporting obligation pursuant to Rule 15Ga-1(c)(3), provide the date of the last payment on the last asset-backed security outstanding that was issued by or issued by an affiliate of the securitizer.

### PART II: FINDINGS AND CONCLUSIONS OF THIRD-PARTY DUE DILIGENCE REPORTS

**Item 2.01 Findings and Conclusions of a Third Party Due Diligence Report Obtained by the Issuer**

Provide the disclosures required by Rule 15Ga-2 (17 CFR 240.15Ga-2) for any third-party due diligence report obtained by the issuer.

**Item 2.02 Findings and Conclusions of a Third-Party Due Diligence Report Obtained by the Underwriter**

Provide the disclosures required by Rule 15Ga-2 (17 CFR 240.15Ga-2) for any third party engaged by the underwriter.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the reporting entity has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

________________________________________ (Securitizer or Underwriter)

Date ______________________________________________

___________________________________________________ (Signature)*

*Print name and title of the signing officer under his signature.

**PART 249b—FURTHER FORMS, SECURITIES EXCHANGE ACT OF 1934**

18. The authority citation for part 249b continues to read in part as follows:

**Authority**: 15 U.S.C. 78a et seq., unless otherwise noted;

* * * * *

19. Form NRSRO (referenced in §249b.300) is amended to read as follows:

## Form NRSRO

# APPLICATION FOR REGISTRATION AS A NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION (NRSRO)

**Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.**

SEC 1541 (4-09)

## APPLICATION FOR REGISTRATION AS A NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION (NRSRO)

☐ INITIAL APPLICATION

☐ APPLICATION TO ADD CLASS OF CREDIT RATINGS

☐ APPLICATION SUPPLEMENT
Items and/or Exhibits Supplemented:

______________________________

☐ ANNUAL CERTIFICATION

☐ UPDATE OF REGISTRATION
Items and/or Exhibits Amended:

______________________________

☐ WITHDRAWAL FROM REGISTRATION

**Important: Refer to Form NRSRO Instructions for General Instructions, Item-by-Item Instructions, an Explanation of Terms, and the Disclosure Reporting Page (NRSRO). "You" and "your" mean the person filing or furnishing, as applicable, this Form NRSRO and any credit rating affiliate identified in Item 3.**

1. A. Your full name:

________________________________________________________

B. (i) Name under which your credit rating business is primarily conducted, if different from Item 1A:

________________________________________________________

(ii) Any other name under which your credit rating business is conducted and where it is used (other than the name of a credit rating affiliate identified in Item 3):

________________________________________________________

C. Address of your principal office (do not use a P.O. Box):

________________________________________________________
(Number and Street) (City) (State/Country) (Zip/Postal Code)

D. Mailing address, if different:

________________________________________________________
(Number and Street) (City) (State/Country) (Zip/Postal Code)

E. Contact person (See Instructions):

________________________________________________________
(Name and Title)

________________________________________________________
(Number and Street) (City) (State/Country) (Zip/Postal Code)

**CERTIFICATION:**

The undersigned has executed this Form NRSRO on behalf of, and on the authority of, the Applicant/NRSRO. The undersigned, on behalf of the Applicant/NRSRO, represents that the information and statements contained in this Form, including Exhibits and attachments, all of which are part of this Form, are accurate in all significant respects. If this is an ANNUAL CERTIFICATION, the undersigned, on behalf of the NRSRO, represents that the NRSRO's application on Form NRSRO, as amended, is accurate in all significant respects.

______________________________________________
(Date) (Name of the Applicant/NRSRO)

By:

______________________________________________
(Signature) (Print Name and Title)

2. A. Your legal status:

☐ Corporation ☐ Limited Liability Company ☐ Partnership ☐ Other (specify) __________

B. Month and day of your fiscal year end: ______________________________

C. Place and date of your formation (i.e., state or country where you were incorporated, where your partnership agreement was filed, or where you otherwise were formed):

State/Country of formation: ____________________ Date of formation: __________

3. Your credit rating affiliates (See Instructions):

______________________________________________
(Name) (Address)

______________________________________________
(Name) (Address)

______________________________________________
(Name) (Address)

______________________________________________
(Name) (Address)

______________________________________________
(Name) (Address)

4. The designated compliance officer of the Applicant/NRSRO (See Instructions):

______________________________________________
(Name and Title)

______________________________________________
(Number and Street) (City) (State/Country) (Postal Code)

5. Describe in detail how this Form NRSRO and Exhibits 1 through 9 to this Form NRSRO will be made publicly and freely available on an easily accessible portion of the corporate Internet website of the Applicant/NRSRO (See Instructions):

______________________________________________

______________________________________________

______________________________________________

**6. COMPLETE ITEM 6 ONLY IF THIS IS AN INITIAL APPLICATION, APPLICATION SUPPLEMENT, OR APPLICATION TO ADD A CLASS OF CREDIT RATINGS.**

A. Indicate below the classes of credit ratings for which the Applicant/NRSRO is applying to be registered. For each class, indicate the approximate number of obligors, securities, and money market instruments in that class as of the date of this application for which the Applicant/NRSRO has an outstanding credit rating and the approximate date the Applicant/NRSRO began issuing credit ratings as a "credit rating agency" in that class on a continuous basis through the present (See Instructions):

| Class of credit ratings | Applying for registration | Approximate number currently outstanding | Approximate date issuance commenced |
|---|---|---|---|
| **financial institutions as that term is defined in section 3(a)(46) of the Exchange Act (15 U.S.C. 78c(a)(46)), brokers as that term is defined in section 3(a)(4) of the Exchange Act (15 U.S.C. 78c(a)(4)), and dealers as that term is defined in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5))** | ☐ | | |
| **insurance companies as that term is defined in section 3(a)(19) of the Exchange Act (15 U.S.C. 78c(a)(19))** | ☐ | | |
| **corporate issuers** | ☐ | | |
| **issuers of asset-backed securities as that term is defined in 17 CFR 229.1101(c)** | ☐ | | |
| **issuers of government securities as that term is defined in section 3(a)(42) of the Exchange Act (15 U.S.C. 78c(a)(42)), municipal securities as that term is defined in section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)), and foreign government securities** | ☐ | | |

B. Briefly describe how the Applicant/NRSRO makes the credit ratings in the classes indicated in Item 6A readily accessible for free or for a reasonable fee (See Instructions):

_______________________________________________

_______________________________________________

_______________________________________________

C. Check the applicable box and attach certifications from qualified institutional buyers, if required (See Instructions):

☐ The Applicant/NRSRO is attaching ________ certifications from qualified institutional buyers to this application. Each is marked "Certification from Qualified Institutional Buyer."

☐ The Applicant/NRSRO is exempt from the requirement to file certifications from qualified institutional buyers pursuant to section 15E(a)(1)(D) of the Exchange Act.

**Note: You are not required to make a Certification from a Qualified Institutional Buyer filed with this Form NRSRO publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep these certifications confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the certifications confidential upon request to the extent permitted by law.**

7. DO NOT COMPLETE ITEM 7 IF THIS IS AN INITIAL APPLICATION.

A. Indicate below the classes of credit ratings for which the NRSRO is currently registered. For each class, indicate the approximate number of obligors, securities, and money market instruments in that class for which the NRSRO had an outstanding credit rating as of the most recent calendar year end and the approximate date the NRSRO began issuing credit ratings as a "credit rating agency" in that class on a continuous basis through the present (See Instructions):

| Class of credit rating | Currently registered | Approximate number outstanding as of the most recent calendar year end | Approximate date issuance commenced |
|---|---|---|---|
| **financial institutions as that term is defined in section 3(a)(46) of the Exchange Act (15 U.S.C. 78c(a)(46)), brokers as that term is defined in section 3(a)(4) of the Exchange Act (15 U.S.C. 78c(a)(4)), and dealers as that term is defined in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5))** | ☐ | | |
| **insurance companies as that term is defined in section 3(a)(19) of the Exchange Act (15 U.S.C. 78c(a)(19))** | ☐ | | |
| **corporate issuers** | ☐ | | |
| **issuers of asset-backed securities as that term is defined in 17 CFR 229.1101(c)** | ☐ | | |
| **issuers of government securities as that term is defined in section 3(a)(42) of the Act (15 U.S.C. 78c(a)(42)), municipal securities as that term is defined in section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)), and foreign government securities** | ☐ | | |

B. Briefly describe how the NRSRO makes the credit ratings in the classes indicated in Item 7A readily accessible for free or for a reasonable fee (See Instructions):

________________________________________

________________________________________

________________________________________

| | |
|---|---|
| 8. Answer each question. Provide information that relates to a "Yes" answer on a Disclosure Reporting Page (NRSRO) and submit the Disclosure Reporting Page with this Form NRSRO (See Instructions). You are not required to make any disclosure reporting pages submitted with this Form publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep any disclosure reporting pages confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the disclosure reporting pages confidential upon request to the extent permitted by law. | |
| | YES NO |

| | | |
|---|---|---|
| A. Has the Applicant/NRSRO or any person within the Applicant/NRSRO committed or omitted any act, or been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Securities Exchange Act of 1934, been convicted of any offense specified in section 15(b)(4)(B) of the Securities Exchange Act of 1934, or been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Securities Exchange Act of 1934 in the ten years preceding the date of the initial application of the Applicant/NRSRO for registration as an NRSRO or at any time thereafter? | ☐ | ☐ |
| B. Has the Applicant/NRSRO or any person within the Applicant/NRSRO been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Securities Exchange Act of 1934, or been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction in the ten years preceding the date of the initial application of the Applicant/NRSRO for registration as an NRSRO or at any time thereafter? | ☐ | ☐ |
| C. Is any person within the Applicant/NRSRO subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO? | ☐ | ☐ |

9. **Exhibits** (See Instructions).

**Exhibit 1.** Credit ratings performance measurement statistics.

☐ Exhibit 1 is attached and made a part of this Form NRSRO.

**Exhibit 2.** A description of the procedures and methodologies used in determining credit ratings.

☐ Exhibit 2 is attached and made a part of Form NRSRO.

**Exhibit 3.** Policies or procedures adopted and implemented to prevent the misuse of material, nonpublic information.

☐ Exhibit 3 is attached and made a part of this Form NRSRO.

**Exhibit 4.** Organizational structure.

☐ Exhibit 4 is attached to and made a part of this Form NRSRO.

**Exhibit 5.** The code of ethics or a statement of the reasons why a code of ethics is not in effect.

☐ Exhibit 5 is attached to and made a part of this Form NRSRO.

**Exhibit 6.** Identification of conflicts of interests relating to the issuance of credit ratings.

☐ Exhibit 6 is attached to and made a part of this Form NRSRO.

**Exhibit 7.** Policies and procedures to address and manage conflicts of interest.

☐ Exhibit 7 is attached to and made a part of this Form NRSRO.

**Exhibit 8.** Certain information regarding the credit rating agency's credit analysts and credit analyst supervisors.

☐ Exhibit 8 is attached to and made a part of this Form NRSRO.

**Exhibit 9.** Certain information regarding the credit rating agency's designated compliance officer.

☐ Exhibit 9 is attached to and made a part of this Form NRSRO.

**Exhibit 10.** A list of the largest users of credit rating services by the amount of net revenue earned from the user during the fiscal year ending immediately before the date of the initial application.

☐ Exhibit 10 is attached to and made a part of this Form NRSRO.

**Note: You are not required to make this Exhibit publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.**

**Exhibit 11.** Audited financial statements for each of the three fiscal or calendar years ending immediately before the date of the initial application.

☐ Exhibit 11 is attached to and made a part of this Form NRSRO.

**Note: You are not required to make this Exhibit publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.**

**Exhibit 12.** Information regarding revenues for the fiscal or calendar year ending immediately before the date of the initial application.

☐ Exhibit 12 is attached to and made a part of this Form NRSRO.

**Note: You are not required to make this Exhibit publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.**

**Exhibit 13.** The total and median annual compensation of credit analysts.

☐ Exhibit 13 is attached and made a part of this Form NRSRO.

**Note: You are not required to make this Exhibit publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law.**

# FORM NRSRO INSTRUCTIONS

## A. GENERAL INSTRUCTIONS.

1. Form NRSRO is the Application for Registration as a Nationally Recognized Statistical Rating Organization ("NRSRO") under Section 15E of the Securities Exchange Act of 1934 ("Exchange Act") and Exchange Act Rule 17g-1. Exchange Act Rule 17g-1 requires an Applicant/NRSRO to use Form NRSRO to:

   - File an initial application to be registered as an NRSRO with the U.S. Securities and Exchange Commission ("Commission");
   - File an application to register for an additional class of credit ratings with the Commission;
   - File an application supplement with the Commission;
   - File an update of registration pursuant to Section 15E(b)(1) of the Exchange Act with the Commission;
   - File an annual certification pursuant to Section 15E(b)(2) of the Exchange Act with the Commission; and
   - Furnish a withdrawal of registration pursuant to Section 15E(e) of the Exchange Act to the Commission.

2. Exchange Act Rule 17g-1(c) requires that an Applicant/NRSRO promptly file with the Commission a written notice if information filed with the Commission in an initial application for registration or in an application to register for an additional class of credit ratings is found to be or becomes materially inaccurate before the Commission has granted or denied the application. The notice must identify the information found to be materially inaccurate. The Applicant/NRSRO must also promptly file with the Commission accurate and complete information as an application supplement on Form NRSRO.

3. Pursuant to Exchange Act Rule 17g-1(i), an NRSRO must make its current Form NRSRO and information and documents filed in Exhibits 1 through 9 to Form NRSRO publicly and freely available on an easily accessible portion of its corporate Internet website within 10 business days after the date of the Commission Order granting an initial application for registration as an

NRSRO or an application to register for an additional class of credit ratings and within 10 business days after filing with or furnishing to, as applicable, the Commission an update of registration, annual certification, or withdrawal from registration on Form NRSRO.

The certifications from qualified institutional buyers, disclosure reporting pages, and Exhibits 10 through 13 are not required to be made publicly available by the NRSRO pursuant to Rule 17g-1(i). An Applicant/NRSRO may request that the Commission keep confidential the certifications from qualified institutional buyers, the disclosure reporting pages, and the information and documents in Exhibits 10 – 13 filed with the Commission. An Applicant/NRSRO seeking confidential treatment for these submissions should mark each page "Confidential Treatment" and comply with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep this information confidential to the extent permitted by law.

4. Section 15E(a)(2) of the Exchange Act prescribes time periods and requirements for the Commission to grant or deny an initial application for registration as an NRSRO. These time periods also apply to an application to register for an additional class of credit ratings.

5. Type or clearly print all information. Use only the current version of Form NRSRO or a reproduction of it.

6. Section 15E of the Exchange Act (15 U.S.C. 78o-7) authorizes the Commission to collect the Information on Form NRSRO from an Applicant/NRSRO. The principal purposes of Form NRSRO are to determine whether an Applicant should be granted registration as an NRSRO, whether an NRSRO should be granted registration in an additional class of credit ratings, whether an NRSRO continues to meet the criteria for registration as an NRSRO, for an NRSRO to withdraw from registration, and to provide information about an NRSRO to users of credit ratings. Intentional misstatements or omissions may constitute federal criminal violations under 18 U.S.C. 1001.

The information collection is in accordance with the clearance requirements of Section 3507 of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507). The Commission may not conduct or sponsor, and you are not required to respond to, a collection of information unless it displays a valid Office of Management and Budget (OMB) control number. The time required to complete and file or furnish, as applicable, this form, will vary depending on individual circumstances. The estimated average time to complete an initial application is displayed on the facing page of this Form. Send comments regarding this burden estimate or suggestions for reducing the burden to

Chief Information Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549 or PRA Mailbox@sec.gov.

7. Under Exchange Act Rule 17g-2(b)(10), an NRSRO must retain copies of all Form NRSROs (including Exhibits, accompanying information, and documents) filed with or furnished to, as applicable, the Commission. Exchange Act Rule 17g-2(c) requires that these records be retained for three years after the date the record is made.

8. An Applicant must file with the Commission at the address indicated below two paper copies of an initial application for registration as an NRSRO under Exchange Act Rule 17g-1(a), an application to register for an additional class of credit ratings under Exchange Act Rule 17g-1(b), a supplement to an initial application or application to register for an additional class of credit ratings under Exchange Act Rule 17g-1(c), or a withdrawal of an initial application or an application to register for an additional class of credit ratings under Exchange Act Rule 17g-1(d).

ADDRESS - The mailing address for Form NRSRO is:

U. S. Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549

After registration, an NRSRO must file with or furnish to, as applicable, the Commission electronically in the format required by the EDGAR Filer Manual, as defined in Rule 11 of Regulation S-T, an update of registration under Exchange Act Rule 17g-1(e), an annual certification under Exchange Act Rule 17g-1(f), or a withdrawal from registration under Exchange Act Rule 17g-1(g).

9. A Form NRSRO will be considered filed with or furnished to, as applicable, the Commission on the date the Commission receives a complete and properly executed Form NRSRO that follows

all applicable instructions for the Form, including the instructions in Item A.8 with respect to how a Form NRSRO must be filed with or furnished to the Commission.

10. An NRSRO is subject to applicable fines, penalties, and other available sanctions set forth in Sections 15E, 21, 21A, 21B, 21C, and 32 of the Exchange Act (15 U.S.C. 78o-7, 78u, 78u-1, 78u-2, 78u-3, and 78ff, respectively) for violations of the securities laws.

**B. INSTRUCTIONS FOR AN INITIAL APPLICATION**

An Applicant applying to be registered with the Commission as an NRSRO must file with the Commission an initial application on Form NRSRO. To complete an initial application:

- Check the "INITIAL APPLICATION" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 6, and 8. (See Instructions below for each Item). Enter "None" or "N/A" where appropriate.
- Unless exempt from the requirement, attach certifications from qualified institutional buyers, marked "Certification from Qualified Institutional Buyer" (See Instructions below for Item 6C).
- Attach Exhibits 1 through 13 (See Instructions below for each Exhibit).
- Execute the Form.

The Applicant must promptly file with the Commission a written notice if information submitted to the Commission in an initial application is found to be or becomes materially inaccurate prior to the date of a Commission order granting or denying the application. The notice must identify the information found to be materially inaccurate. The Applicant also must promptly file with the Commission an application supplement on Form NRSRO (See instructions below for an application supplement).

**C. INSTRUCTIONS FOR AN APPLICATION TO ADD A CLASS OF CREDIT RATINGS**

An NRSRO applying to register for an additional class of credit ratings must file with the Commission an application on Form NRSRO. To complete an application to register for an additional class of credit ratings:

- Check the "APPLICATION TO ADD CLASS OF CREDIT RATINGS" box at the top of Form NRSRO.

- Complete Items 1, 2, 3, 4, 5, 6, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information in an Item on a previously submitted Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- Unless exempt from the requirement, attach certifications from qualified institutional buyers for the additional class of credit ratings marked "Certification from Qualified Institutional Buyer" (See Instructions below for Item 6C).
- If any information in an Exhibit previously submitted is materially inaccurate, update that information.
- Execute the Form.

The Applicant must promptly file with the Commission a written notice if information submitted to the Commission in an application to add a class of credit ratings is found to be or becomes materially inaccurate prior to the date of a Commission order granting or denying the application. The notice must identify the information found to be materially inaccurate. The Applicant also must promptly file with the Commission an application supplement on Form NRSRO (See instructions below for an application supplement).

**D. INSTRUCTIONS FOR AN APPLICATION SUPPLEMENT**

An Applicant must file an application supplement with the Commission on Form NRSRO if information submitted to the Commission in a pending initial application for registration as an NRSRO or a pending application to register for an additional class of credit ratings is found to be or becomes materially inaccurate. To complete an application supplement:

- Check the "APPLICATION SUPPLEMENT" box at the top of Form NRSRO.
- Indicate on the line provided under the box the Item(s) or Exhibit(s) being supplemented.
- Complete Items 1, 2, 3, 4, 5 and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If supplementing an initial application, also complete Item 6. If supplementing an application for registration in an additional class of credit ratings, also complete Items 6 and 7. If any information in an Item on a

previously submitted Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.

- If a certification from a qualified institutional buyer is being updated or a new certification is being added, attach the updated or new certification.
- If an Exhibit is being updated, attach the updated Exhibit.
- Execute the Form.

## E. INSTRUCTIONS FOR AN UPDATE OF REGISTRATION

After registration is granted, Section 15E(b)(1) of the Exchange Act requires that an NRSRO must promptly amend its application for registration if information or documents provided in a previously submitted Form NRSRO become materially inaccurate. This requirement does not apply to Item 7 and Exhibit 1, which only are required to be updated annually with the annual certification. It also does not apply to Exhibits 10 – 13 and the certifications from qualified institutional buyers, which are not required to be updated on Form NRSRO after registration. An NRSRO amending its application for registration must file with the Commission an update of its registration on Form NRSRO. To complete an update of registration:

- Check the "UPDATE OF REGISTRATION" box at the top of Form NRSRO.
- Indicate on the line provided under the box the Item(s) or Exhibit(s) being updated.
- Complete Items 1, 2, 3, 4, 5, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information in an Item on a previously submitted Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- If an Exhibit is being updated, attach the updated Exhibit.
- Execute the Form.

## F. INSTRUCTIONS FOR ANNUAL CERTIFICATIONS

After registration is granted, Section 15E(b)(2) of the Exchange Act requires that an NRSRO file with the Commission an annual certification not later than 90 days after the end of each calendar year. The annual certification must be filed with the Commission on Form NRSRO and must include an update of the information in Item 7 and the credit rating transition and default rates submitted in Exhibit 1, a certification that the information and documents on or with Form NRSRO continue to be accurate (use the certification on the Form), and a list of material changes to the application for registration that occurred during the previous calendar year. To complete an annual certification:

- Check the "ANNUAL CERTIFICATION" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information in an Item on the previously submitted Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- If any information in a non-confidential Exhibit previously submitted is materially inaccurate, update that information. (Note: After registration, Exhibits 10 through 13 are not required to be made publicly available by the NRSRO pursuant to Exchange Act Rule 17g-1(i) and they should not be updated with the filing of the annual certification. Instead, similar information must be filed with the Commission not more than 90 days after the end of each fiscal year under Exchange Act Rule 17g-3.).
- Attach a list of all material changes made to the information or documents in the application for registration of the NRSRO that occurred during the previous calendar year.
- Execute the Form.

**G. INSTRUCTIONS FOR A WITHDRAWAL FROM REGISTRATION**

Section 15E(e)(1) of the Exchange Act provides that an NRSRO may voluntarily withdraw its registration with the Commission. Under Exchange Act Rule, 17g-1(g), to withdraw from registration, an NRSRO must furnish the Commission with a notice of withdrawal from registration on Form NRSRO. The withdrawal from registration will become effective 45 calendar days after the withdrawal from registration is furnished to the Commission upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors. To complete a withdrawal from registration:

- Check the "WITHDRAWAL FROM REGISTRATION" box at the top of Form NRSRO.
- Complete Items 1, 2, 3, 4, 5, 7, and 8 on the Form following all applicable instructions for each Item (See Instructions below for each Item). If any information on a previously submitted Form NRSRO is materially inaccurate, update that information. Enter "None" or "N/A" where appropriate. Complete each Item even if the Item is not being updated.
- Execute the Form.

## H. INSTRUCTIONS FOR SPECIFIC LINE ITEMS

**Item 1A.** Provide the name of the person (e.g., XYZ Corporation) that is filing or furnishing, as applicable, the Form NRSRO. This means the name of the person that is applying for registration as an NRSRO or is registered as an NRSRO and not the name of the individual that is executing the Form.

**Item 1E.** The individual listed as the contact person must be authorized to receive all communications and papers from the Commission and must be responsible for their dissemination within the Applicant/NRSRO.

**Certification.** The certification must be executed by the Chief Executive Officer or the President of the person that is filing or furnishing, as applicable, the Form NRSRO or an individual with similar responsibilities.

**Item 3.** Identify credit rating affiliates that issue credit ratings on behalf of the person filing or furnishing, as applicable, the Form NRSRO in one or more of the classes of credit ratings identified in Item 6 or Item 7. A "credit rating affiliate" is a separate legal entity or a separately identifiable department or division thereof that determines credit ratings that are credit ratings of the person filing or furnishing, as applicable, the Form NRSRO. The information in Items 4 – 8 and all the Exhibits must incorporate information about the credit ratings, methodologies, procedures, policies, financial condition, results of operations, personnel, and organizational structure of each credit rating affiliate identified in Item 3, as applicable. Any credit rating determined by a credit rating affiliate identified in Item 3 will be treated as a credit rating issued by the person filing or furnishing, as applicable, the Form NRSRO for purposes of Section 15E of the Exchange Act and the Commission's rules thereunder. The terms "Applicant" and

"NRSRO" as used on Form NRSRO and the Instructions for the Form mean the person filing or furnishing, as applicable, the Form NRSRO and any credit rating affiliate identified in Item 3.

**Item 4.** Section 15E(j)(1) of the Exchange Act requires an NRSRO to designate a compliance officer responsible for administering the policies and procedures of the NRSRO established pursuant to Sections 15E(g) and (h) of the Exchange Act (respectively, to prevent the misuse of material nonpublic information and address and manage conflicts of interest) and for ensuring compliance with applicable securities laws, rules, and regulations.

**Item 5.** Section 15E(a)(3) of the Exchange Act and Exchange Act Rule 17g-1(i) require an NRSRO to make Form NRSRO and Exhibits 1 – 9 to Form NRSRO filed with the Commission publicly and freely available on an easily accessible portion of the NRSRO's corporate Internet website within 10 business days after the date of the Commission order granting an initial application for registration as an NRSRO or an application to register for an additional class of credit ratings and within 10 business days after filing with or furnishing to, as applicable, the Commission an amendment, annual certification, or withdrawal from registration on Form NRSRO. The certifications from qualified institutional investors, Disclosure Reporting Pages, and Exhibits 10 through 13 are not required to be made publicly available on the NRSRO's corporate Internet website. Describe how the current Form NRSRO and Exhibits 1 – 9 will be made publicly and freely available on an easily accessible portion of the NRSRO's corporate Internet website by providing the Internet address and link to the Form and Exhibits.

**Item 6.** Complete Item 6 only if filing an initial application for registration, an application to be registered in an additional class of credit ratings, or an application supplement.

**Item 6A.** Pursuant to Section 15E(a)(1)(B)(vii) of the Exchange Act, an Applicant applying for registration as an NRSRO must disclose in the application the classes of credit ratings for which the Applicant/NRSRO is applying to be registered. Indicate these classes by checking the appropriate box or boxes. For each class of credit ratings, provide in the appropriate box the approximate number of obligors, securities, and money market instruments in that class for which the Applicant/NRSRO presently has a credit rating outstanding as of the date of the application. In determining this amount, the Applicant/NRSRO must treat as a separately rated security or money market instrument each individually rated security and money market instrument that, for example, is assigned a distinct CUSIP or other unique identifier, has distinct credit enhancement features as compared with other securities or money market instruments of the same issuer, or has a different maturity date as compared with other securities or money market instruments of the same issuer. The Applicant/NRSRO must not include an obligor, security, or money market instrument in more than one class of credit rating. An Applicant/NRSRO must include in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Exchange Act (issuers of asset-backed securities) to the extent not described in Section 3(a)(62)(B)(iv), any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction. For each class of credit ratings, also provide in the appropriate box the approximate date the Applicant/NRSRO began issuing and making readily accessible credit ratings in the class on a continuous basis through the present as a "credit rating agency," as that term is defined in Section 3(a)(61) of the Exchange Act. If there was a period when the Applicant/NRSRO stopped issuing credit ratings in a particular class or stopped operating as a credit rating agency, provide the approximate date the Applicant/NRSRO resumed issuing and making readily accessible credit ratings in that class as a credit rating agency. Refer to the definition of "credit rating agency" in the instructions below (also at 15 U.S.C. 78c(a)(61)) to determine when the Applicant/NRSRO began operating as a "credit rating agency."

**Item 6B.** To meet the definition of "credit rating agency" pursuant to Section 3(a)(61)(A) of the Exchange Act, the Applicant must, among other things, issue "credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee." Briefly describe how the Applicant/NRSRO makes the credit ratings in the classes indicated in Item 6A readily accessible for free or for a reasonable fee. If a person must pay a fee to obtain a credit rating made readily accessible by the Applicant/NRSRO, provide a fee schedule or describe the price(s) charged.

**Item 6C.** If the Applicant/NRSRO is required to file qualified institutional buyer certifications under Section 15E(a)(1)(C) of the Exchange Act file a minimum of 10 certifications from qualified institutional buyers, none of which is affiliated with the Applicant/NRSRO. Each certification may address more than one class of credit ratings. To be registered as an NRSRO for a class of credit ratings identified in Item 6A under "Applying for Registration," the Applicant/NRSRO must file at least two certifications that address the class of credit ratings. If this is an application of an NRSRO to be registered in one or more additional classes of credit ratings, file at least two certifications that address each additional class of credit ratings.

The required certifications must be signed by a person duly authorized by the certifying entity, must be notarized, must be marked "Certification from Qualified Institutional Buyer," and must be in substantially the following form:

"I, [Executing official], am authorized by [Certifying entity] to execute this certification on behalf of [Certifying entity]. I certify that all actions by stockholders, directors, general partners, and other bodies necessary to authorize me to execute this certification have been taken and that [Certifying entity]:

(i) Meets the definition of a 'qualified institutional buyer' as set forth in section 3(a)(64) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(64)) pursuant to the following subsection(s) of 17 CFR 230.144A(a)(1) [insert applicable citations];

(ii) Has seriously considered the credit ratings of [the Applicant/NRSRO] in the course of making some of its investment decisions for at least the three years immediately preceding the date of this certification, in the following classes of credit ratings: [Insert applicable classes of credit ratings]; and

(iii) Has not received compensation either directly or indirectly from [the Applicant/NRSRO] for executing this certification.

[Signature]

Print Name and Title

You are not required to make a Certification from a Qualified Institutional Buyer filed with this Form NRSRO publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep these certifications confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the certifications confidential upon request to the extent permitted by law.

**Item 7.** An Applicant filing Form NRSRO to apply for registration as an NRSRO should not complete Item 7. An NRSRO filing or furnishing, as applicable, Form NRSRO for any other reason must complete Item 7. The information in Item 7 must be updated on an annual basis with the filing of the annual certification.

**Item 7A.** Indicate the classes of credit ratings for which the NRSRO is currently registered by checking the appropriate box or boxes. For each class of credit ratings, provide in the appropriate box the approximate number of obligors, securities, and money market instruments in that class for which the NRSRO had a credit rating outstanding as of the end of the most recently ended calendar year. In determining this amount, NRSRO must treat as a separately rated security or money market instrument each individually rated security and money market instrument that, for example, is assigned a distinct CUSIP or other unique identifier, has distinct credit enhancement features as compared with other securities or money market instruments of the same issuer, or has a different maturity date as compared with other securities or money market instruments of the same issuer. The NRSRO must not include an obligor, security, or money market instrument in more than one class of credit rating. An NRSRO must include in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Exchange Act (issuers of asset-backed securities) to the extent not described in Section 3(a)(62)(B)(iv), any rated security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction. For each class of credit ratings, also provide in the appropriate box the approximate date the NRSRO began issuing and making readily accessible credit ratings in the class on a continuous basis through the present as a "credit rating agency," as that term is defined in Section 3(a)(61) of the Exchange Act. If there was a period when the NRSRO stopped issuing credit ratings in a particular class or stopped operating as a credit rating agency, provide the approximate date the NRSRO resumed issuing and making readily accessible credit ratings in that class as a credit rating agency. Refer to the definition of "credit rating agency" in the instructions below (also at 15 U.S.C. 78c(a)(61)) to determine when the NRSRO began operating as a "credit rating agency."

**Item 7B.** Briefly describe how the NRSRO makes the credit ratings in the classes indicated in Item 7A readily accessible for free or for a reasonable fee. If a person must pay a fee to obtain a credit rating made readily accessible by the NRSRO, provide a fee schedule or describe the price(s) charged.

**Item 8.** Answer each question by checking the appropriate box. Refer to the definition of "person within an Applicant/NRSRO" set forth below to determine the persons to which the questions apply. Information that relates to an affirmative answer must be provided on a Disclosure Reporting Page (NRSRO) and filed with Form NRSRO. Submit a separate Disclosure Reporting Page (NRSRO) for each person that: (a) has committed or omitted any act, or has been subject to an order or finding, enumerated in subparagraphs (A), (D), (E), (G), or (H) of section 15(b)(4) of the Securities Exchange Act of 1934, has been convicted of any offense specified in section 15(b)(4)(B) of the Securities Exchange Act of 1934, or has been enjoined from any action, conduct, or practice specified in section 15(b)(4)(C) of the Securities Exchange Act of 1934; (b) has been convicted of any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4) of the Securities Exchange Act of 1934, or has been convicted of a substantially equivalent crime by a foreign court of competent jurisdiction; or (c) is subject to any order of the Commission barring or suspending the right of the person to be associated with an NRSRO. The Disclosure Reporting Page (NRSRO) is attached to these instructions. Note: the definition of "person within an Applicant/NRSRO" is narrower than the definition of "person associated with a nationally recognized statistical rating organization" in Section 3(a)(63) of the Exchange Act. You are not required to make any disclosure reporting pages submitted with this Form NRSRO publicly available on your corporate Internet website pursuant to Exchange Act Rule 17g-1(i). You may request that the Commission keep any disclosure reporting pages confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment. The Commission will keep the disclosure reporting pages confidential upon request to the extent permitted by law.

**Item 9.** Exhibits. Section 15E(a)(1)(B) of the Exchange Act requires a credit rating agency's application for registration as an NRSRO to contain certain specific information and documents and, pursuant to Section 15E(a)(1)(B)(x), any other information and documents concerning the applicant and any person associated with the applicant that the Commission requires as necessary or appropriate in the public interest or for the protection of investors. If any information or document required to be included with any Exhibit is maintained in a language other than English, file a copy of the original document and a version of the document translated into English. Attach a certification by an authorized person that the translated version is a true, accurate, and complete English translation of the information or document. Attach the

Exhibits to Form NRSRO in numerical order. Bind each Exhibit separately, and mark each Exhibit or bound volume of the Exhibit with the appropriate Exhibit number. The information in the Exhibits must be sufficiently detailed to allow for verification. The information and documents in Exhibits 1 through 9 must be made publicly and freely available on an easily accessible portion of the NRSRO's corporate Internet website pursuant to Exchange Act Rule 17g-1(i). The information and documents in Exhibits 10 through 13 are not required to be made publicly available on the NRSRO's corporate Internet website pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep these Exhibits confidential by marking each page of them "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in these Exhibits confidential upon request to the extent permitted by law. (Note: After registration, Exhibits 10 through 13 are not required to be made publicly available by the NRSRO pursuant to Exchange Act Rule 17g-1(i) and they should not be updated with the filing of the annual certification. Instead, similar information must be filed with the Commission not more than 90 days after the end of each fiscal year pursuant to Exchange Act Rule 17g-3.).

**Exhibit 1.** (1) An Applicant/NRSRO must provide in this Exhibit performance measurement statistics consisting of transition and default rates for each class and subclass of credit ratings (listed below) for which it is seeking registration as an NRSRO or for which it is registered as an NRSRO. For each applicable class and subclass of credit ratings, an Applicant/NRSRO must provide transition and default rates for 1-, 3-, and 10-year time periods through the most recent calendar year end. The transition and default rates for each time period must be presented together in tabular form ("Transition/Default Matrix"). The Transition/Default Matrices must be presented on a calendar year basis even if the Applicant/NRSRO has a fiscal year end other than December 31. Exhibit 1 must be updated annually with the filing of the NRSRO's Annual Certification pursuant to Exchange Act Rule 17g-1(f). Pursuant to Exchange Act Rule 17g-1(i), an NRSRO must make the Annual Certification publicly and freely available on an easily accessible portion of the NRSRO's corporate Internet website within 10 business days after the filing and must make its up-to-date Exhibit 1 freely available in writing to any individual who requests a copy of the Exhibit. The classes and subclasses of credit ratings for which an Applicant/NRSRO must provide Transition/Default Matrices are (as applicable):

(A) The class of credit ratings described in Section 3(a)(62)(B)(i) of the Exchange Act (financial institutions, brokers, or dealers).

(B) The class of credit ratings described in Section 3(a)(62)(B)(ii) of the Exchange Act (insurance companies);

(C) The class of credit ratings described in Section 3(a)(62)(B)(iii) of the Exchange Act (corporate issuers);

(D) The following subclasses of credit ratings described in Section 3(a)(62)(B)(iv) of the Exchange Act (issuers of asset-backed securities) and, to the extent not described in Section 3(a)(62)(B)(iv), any security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction:

(i) Residential mortgage backed securities ("RMBS") (for the purposes of Exhibit 1, RMBS means a securitization primarily of residential mortgages);

(ii) Commercial mortgage backed securities ("CMBS") (for the purposes of Exhibit 1, CMBS means a securitization primarily of commercial mortgages);

(iii) Collateralized loan obligations ("CLOs") (for the purposes of Exhibit 1, a CLO means a securitization primarily of commercial loans);

(iv) Collateralized debt obligations ("CDOs) (for the purposes of Exhibit 1, a CDO means a securitization primarily of other debt instruments such as RMBS, CMBS, CLOs, CDOs, other asset backed securities, and corporate bonds);

(v) Asset-backed commercial paper ("ABCP") (for the purposes of Exhibit 1, ABCP means short term notes issued by a structure that securitizes a variety of financial assets (e.g., trade receivables or credit card receivables), which secure the notes);

(vi) other asset-backed securities ("other ABS") (for the purposes of Exhibit 1, other ABS means a securitization primarily of auto loans, auto leases, floor plan financings, credit card receivables, student loans, consumer loans, or equipment leases); and

(vii) other structured finance products ("other SFPs") (for the purposes of Exhibit 1, other SFPs means any structured finance product not identified in subparagraphs (i) through (vi) above -- the Applicant/NRSRO must provide a description of the products in this subclass); and

(E) The following subclasses of credit ratings described in Section 3(a)(62)(B)(v) of the Exchange Act (issuers of government securities, municipal securities, or securities issued by a foreign government):

(i) Sovereign issuers;

(ii) United States public finance; and

(iii) International public finance.

(2) The Transition/Default Matrices for applicable classes and subclasses of credit ratings must be presented in the same order that the classes and subclasses of credit ratings are identified in paragraphs (1)(A) through (E) above. For a given class or subclass, Transition/Default Matrices must be presented in the following order: 1-year matrix, 3-year matrix and then 10-year matrix. If the Applicant/NRSRO has not been determining credit ratings in the applicable class or subclass for the length of time necessary to produce a 1-, 3-, and/or 10-year Transition/Default Matrix, it must explain that fact in the location where the Transition/Default Matrix would have been presented in the Exhibit. The Applicant/NRSRO must clearly define, after the presentation of all applicable Transition/Default Matrices, each symbol, number, or score in the rating scale used by the Applicant/NRSRO to denote a credit rating category and notches within a category for each class and subclass of credit ratings in any Transition/Default Matrix presented in the Exhibit. In, addition the Applicant/NRSRO must clearly explain the conditions under which it classifies obligors, securities, or money market instruments as being in default. Next, the Applicant/NRSRO must provide the uniform resource locator (URL) of its corporate Internet website where the credit rating histories required to be disclosed pursuant to 17 CFR 17g-7(b) will be located (in the case of an Applicant) or are located (in the case of an NRSRO). Exhibit 1 must contain no performance measurement statistics or information other than as described in, and required by, these Instructions for Exhibit 1; except that the Applicant/NRSRO may provide after the presentation of all required Transition/Default Matrices and other disclosures the Internet website URLs where other information relating to performance measurement statistics of the Applicant/NRSRO is located.

(3) The Transition/Default Matrices must be presented using the format of the sample matrix ("Sample Matrix") below. The top row of a Transition/Default Matrix (the "header row") must contain column headings. The first and second cells in the header row must contain the headings, respectively: "Credit Rating Scale" and "Number of Ratings Outstanding as of [insert applicable date]." The applicable

date is the date 1, 3, or 10 years prior to the most recent calendar year end depending on whether the Transition/Default Matrix is for a 1-, 3-, or 10-year period. The next sequence of cells in the header row must contain, from left to right, each symbol, number, or score in the rating scale used by the Applicant/NRSRO to denote a credit rating category and notches within a category for the applicable class or subclass of credit ratings in descending order from the highest to the lowest notch. The Applicant/NRSRO must not include a "default" category if its rating scale has such a category. The next headings must be in the following order, from left to right, "Default" (see explanation below), "Paid Off" (see explanation below), and "Withdrawn (other)" (see explanation below). The first column of a Transition/Default Matrix must have a separate cell containing each symbol, number, or score in the rating scale used by the Applicant/NRSRO to denote a credit rating category and notches within a category for the applicable class or subclass of credit ratings in descending order from the highest to the lowest notch. The Applicant/NRSRO must not include a "default" category in the column if its rating scale has such a category. The last cell of the first column must contain the word "Total." Finally, the Transition/Default Matrix must have a title identifying the applicable class or subclass of credit ratings, the period covered, and the start date and end date of the period.

The Transition/Default Matrix must resemble the Sample Matrix below except that the number of credit rating symbols depicted in the cells of the first column and header row of a matrix will depend on the number of notches in the applicable rating scale of the Applicant/NRSRO (excluding a "default" category).

**Corporate Issuers – 10-Year Transition and Default Rates**
(December 31, 2000 through December 31, 2010)

| Credit Rating Scale | Number Of Ratings Outstanding as of 12/31/2000 | AAA | AA | A | BBB | BB | B | CCC | CC | C | Default | Paid Off | Withdrawn (other) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| AAA | 10 | 50% | 10% | | | | | | | | | 40% | |
| AA | 2000 | 1% | 39% | 12% | 10% | 8% | 5% | 4% | | | 1% | 19% | 1% |
| A | 4000 | | 6% | 34% | 15% | 10% | 6% | 4% | 3% | | 2% | 18% | 2% |
| BBB | 3600 | | 2% | 9% | 28% | 15% | 10% | 6% | 5% | 1% | 4% | 17% | 3% |
| BB | 1000 | | | 2% | 4% | 20% | 14% | 5% | | | 2% | 16% | 37% |
| B | 500 | | | 1% | 3% | 6% | 20% | 20% | 15% | | 15% | 15% | 5% |
| CCC | 300 | | | | | 4% | 6% | 15% | 25% | 20% | 20% | 4% | 6% |
| CC | 200 | | | | | | 2% | 8% | 10% | 38% | 30% | 2% | 10% |
| C | 160 | | | | | | | 2% | 8% | 10% | 67% | 1% | 12% |
| Total | 11,770 | | | | | | | | | | | | |

(4) An Applicant/NRSRO must populate the cells in the columns and rows of a Transition/Default Matrix in the following manner:

(A) *Second Column Showing Number of Ratings Outstanding as of the Period Start Date.* To populate the cells of this column, the Applicant/NRSRO must determine the number of obligors, securities, and money market instruments in the applicable class or subclass of credit ratings that were assigned an outstanding credit rating as of the period start date (cumulatively, the "start-date cohort"). In determining the start-date cohort, the Applicant/NRSRO must exclude any obligors, securities, or money market instruments that the NRSRO classified as in default as of the start date. Next, the Applicant/NRSRO must determine the number of obligors, securities, and money market instruments in the start-date cohort assigned a credit rating (other than an expected or preliminary credit rating) as of the start date in each notch represented in the "Credit Rating Scale" column. The Applicant/NRSRO must populate the cells of this column with the number of obligors, securities, and/or money market instruments assigned a credit rating in each notch and in the bottom cell the total number of credit ratings in the start-date cohort.

(B) *Rows Representing Credit Rating Notches.* Each row representing a credit rating notch must contain percents indicating the credit rating outcomes of all the obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date. The percents in a row must add up to 100%. To compute the percents for each row representing a notch in the rating scale in the Transition/Default Matrix:

(i) The Applicant/NRSRO must determine the number of obligors, securities, and money market instruments assigned a credit rating at that notch as of the period start-date that were assigned a credit rating at the same notch as of the period end date. This number must be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date and the percent must be entered in the column representing the same notch. To determine this percent, the Applicant/NRSRO must use the credit rating at the notch assigned to the obligor, security, or money market instrument as of the period end date and not a credit rating at any other notch assigned to the obligor, security, or money market instrument between the period start date and the period end date.

(ii) The Applicant/NRSRO must determine the number of obligors, securities, and money market instruments assigned a credit rating at that notch as of the period start date that were assigned a credit rating at each other notch as of the period end date. These numbers must be expressed as percents of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date and the percents must be entered in the columns representing each different notch. To determine these percents, the Applicant/NRSRO must use the credit rating at the notch assigned to the obligor, security, or money market instrument as of the period end date and not a credit rating at any other notch assigned to the obligor, security, or money market instrument between the period start date and the period end date.

(iii) The Applicant/NRSRO must determine the number of obligors, securities, and money market instruments assigned a credit rating at that notch as of the period start date that went into *Default* (see explanation below) at any time during the applicable time period. This number must be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date and the percent must be entered in the *Default* column. To determine this percent, the Applicant/NRSRO must classify an obligor, security, or money market instrument as having gone into *Default* if the conditions in either (a) or (b) (or in both (a) and (b)) are met:

(a) The obligor failed to timely pay principal or interest due according to the terms of an obligation during the applicable period or the issuer of the security or money market instrument failed to timely pay principal or interest due according to the terms of the security or money market instrument during the applicable period; or

(b) The Applicant/NRSRO classified the obligor, security, or money market instrument as having gone into default using its own definition of "default" during the applicable period.

An obligor, security, or money market instrument that goes into in *Default* as defined in this paragraph (4)(B)(iii) must be classified as in *Default* even if the Applicant/NRSRO assigned a credit rating to the obligor, security, or money market instrument at a notch above default in its rating scale on or after the event of *Default* or withdrew the credit rating on or after the event of *Default.*

(iv) The Applicant/NRSRO must determine the number of obligors, securities, and money market instruments assigned a credit rating at that notch as of the period start date that *Paid Off* (see explanation below) at any time during the applicable time period. This number must be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date and the percent must be entered in the *Paid Off* column. To determine this percent, the Applicant/NRSRO must classify an obligor, security, or money market instrument as *Paid Off* if the conditions in either (a) or (b) are met;

(a) The obligor extinguished the obligation during the applicable time period by paying in full all outstanding principal and interest due on the obligation according to the terms of the obligation (e.g., because the obligation matured, was called, or was prepaid); and the Applicant/NRSRO withdrew the credit rating because the obligation was extinguished; or

(b) The issuer of the security or money market instrument extinguished its obligation with respect to the security or money market instrument during the applicable time period by paying in full all outstanding principal and interest due according to the terms of the security or money market instrument (e.g., because the security or money market instrument matured, was called, or was prepaid); and the Applicant/NRSRO withdrew the credit rating for the security or money market instrument because the obligation was extinguished.

(v) The Applicant/NRSRO must determine the number of obligors, securities, and money market instruments assigned a credit rating at that notch as of the period start date for which the Applicant/NRSRO withdrew a credit rating assigned to the obligor, security, or money market instrument at any time during the applicable time period for a reason other than *Default* (as described in paragraph (4)(B)(iii)) or *Paid-Off* (as described in paragraph (4)(B)(iv)). This number must be expressed as a percent of the total number of obligors, securities, and/or money market instruments assigned a credit rating at that notch as of the period start date and the percent must be entered in the *Withdrawn (other)* column. The Applicant/NRSRO must classify the obligor, security, or money market instrument as *Withdrawn (other)* even if the Applicant/NRSRO assigned a credit rating to the obligor, security, or money market instrument after withdrawing its credit rating.

**Exhibit 2.** Provide in this Exhibit a general description of the procedures and methodologies used by the Applicant/NRSRO to determine credit ratings, including unsolicited credit ratings within the classes of credit ratings for which the Applicant/NRSRO is seeking registration or is registered. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the Applicant/NRSRO in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or securities transaction is relied on in determining credit ratings; the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or securities transaction factor into the determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining

initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. An Applicant/NRSRO may provide in Exhibit 2 the location on its corporate Internet website where additional information about the procedures and methodologies is located.

**Exhibit 3.** Provide in this Exhibit a copy of the written policies and procedures established, maintained, and enforced by the Applicant/NRSRO to prevent the misuse of material, nonpublic information pursuant to Section 15E(g) of the Exchange Act and 17 CFR 240.17g-4. Do not include any information that is proprietary or that would diminish the effectiveness of a specific policy or procedure if made publicly available.

**Exhibit 4.** Provide in this Exhibit information about the organizational structure of the Applicant/NRSRO, including, as applicable, an organizational chart that identifies, as applicable, the ultimate and sub-holding companies, subsidiaries, and material affiliates of the Applicant/NRSRO; an organizational chart showing the divisions, departments, and business units of the Applicant/NRSRO; and an organizational chart showing the managerial structure of the Applicant/NRSRO, including the designated compliance officer identified in Item 4.

**Exhibit 5.** Provide in this Exhibit a copy of the written code of ethics the Applicant/NRSRO has in effect or a statement of the reasons why the Applicant/NRSRO does not have a written code of ethics in effect.

**Exhibit 6.** Identify in this Exhibit the types of conflicts of interest relating to the issuance of credit ratings by the Applicant/NRSRO that are material to the Applicant/NRSRO. First, identify the conflicts described in the list below that apply to the Applicant/NRSRO. The Applicant/NRSRO may use the descriptions below to identify an applicable conflict of interest and is not required to provide any further details. Second, briefly describe any other type of conflict of interest relating to the issuance of credit ratings by the Applicant/NRSRO that is not covered in the descriptions below that is material to the Applicant/NRSRO (for example, one the Applicant/NRSRO has established specific policies and procedures to address):

The Applicant/NRSRO is paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.

- The Applicant/NRSRO is paid by obligors to determine credit ratings of the obligors.
- The Applicant/NRSRO is paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the Applicant/NRSRO to determine a credit rating.
- The Applicant/NRSRO is paid by persons for subscriptions to receive or access the credit ratings of the Applicant/NRSRO and/or for other services offered by the Applicant/NRSRO where such persons may use the credit ratings of the Applicant/NRSRO to comply with, and obtain benefits or relief under, statutes and regulations using the term "nationally recognized statistical rating organization."
- The Applicant/NRSRO is paid by persons for subscriptions to receive or access the credit ratings of the Applicant/NRSRO and/or for other services offered by the Applicant/NRSRO where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by the Applicant/NRSRO.
- The Applicant/NRSRO allows persons within the Applicant/NRSRO to:
  - o Directly own securities or money market instruments of, or have other direct ownership interests in, obligors or issuers subject to a credit rating determined by the Applicant/NRSRO.
  - o Have business relationships that are more than arms length ordinary course business relationships with obligors or issuers subject to a credit rating determined by the Applicant/NRSRO.
  - A person associated with the Applicant/NRSRO is a broker or dealer engaged in the business of underwriting securities or money market instruments (identify the person).
  - The Applicant/NRSRO has any other material conflict of interest that arises from the issuances of credit ratings (briefly describe).

**Exhibit 7.** Provide in this Exhibit a copy of the written policies and procedures established, maintained, and enforced by the Applicant/NRSRO to address and manage conflicts of interest pursuant to Section 15E(h) of the Exchange Act. Do not include any information that is proprietary or that would diminish the effectiveness of a specific policy or procedure if made publicly available.

**Exhibit 8.** Provide in this Exhibit the following information about the Applicant/NRSRO's credit analysts and the persons who supervise the credit analysts:

- The total number of credit analysts (including credit analyst supervisors).
- The total number of credit analyst supervisors.
- A general description of the minimum qualifications required of the credit analysts, including education level and work experience (if applicable, distinguish between junior, mid, and senior level credit analysts).
- A general description of the minimum qualifications required of the credit analyst supervisors, including education level and work experience.

**Exhibit 9.** Provide in this Exhibit the following information about the designated compliance officer (identified in Item 4) of the Applicant/NRSRO:

- Name.
- Employment history.
- Post secondary education.
- Whether employed by the Applicant/NRSRO full-time or part-time.

**Exhibit 10.** Provide in this Exhibit a list of the largest users of credit rating services of the Applicant by the amount of net revenue earned by the Applicant attributable to the person during the fiscal year ending immediately before the date of the initial application. First, determine and list the 20 largest <u>issuers</u> and <u>subscribers</u> in terms of net revenue. Next, add to the list any <u>obligor</u> or <u>underwriter</u> that, in terms of net revenue during the fiscal year, equaled or exceeded the 20$^{th}$ largest issuer or subscriber. In making the list, rank the persons in terms of net revenue from largest to smallest and include the net revenue amount for each person. For purposes of this Exhibit:

<u>Net revenue</u> means revenue earned by the Applicant for any type of service or product provided to the person, regardless of whether related to credit rating services, and net of any rebates and allowances the Applicant paid or owes to the person; and

<u>Credit rating services</u> means any of the following: rating an obligor (regardless of whether the obligor or any other person paid for the credit rating); rating an issuer's securities or money market

instruments (regardless of whether the issuer, underwriter, or any other person paid for the credit rating); and providing credit ratings, credit ratings data, or credit ratings analysis to a subscriber. An NRSRO is not required to make this Exhibit publicly available on its corporate Internet website, pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law. (Note: After registration, Exhibit 10 should not be updated with the filing of the annual certification. Instead, similar information must be filed with the Commission not more than 90 days after the end of each fiscal year pursuant to Exchange Act Rule 17g-3).

**Exhibit 11.** Provide in this Exhibit the financial statements of the Applicant, which must include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity, audited by an independent public accountant, for each of the three fiscal or calendar years ending immediately before the date of the Applicant's initial application to the Commission, subject to the following:

- If the Applicant is a division, unit, or subsidiary of a parent company, the Applicant may provide audited consolidated financial statements of its parent company.
- If the Applicant does not have audited financial statements for one or more of the three fiscal or calendar years ending immediately before the date of the initial application, the Applicant may provide unaudited financial statements for the applicable year or years, but must provide audited financial statements for the fiscal or calendar year ending immediately before the date of the initial application.

Attach to the unaudited financial statements a certification by a person duly authorized by the Applicant to make the certification that the person has responsibility for the financial statements and that to the best knowledge of the person making the certification the financial statements fairly present, in all material respects, the Applicant's financial condition, results of operations, and cash flows for the period presented.

An NRSRO is not required to make this Exhibit publicly available on its corporate Internet website, pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law. (Note: After registration, Exhibit 11 should not be updated with the filing of the annual certification. Instead, similar information must be filed with the Commission not more than 90 days after the end of each fiscal year pursuant to Exchange Act Rule 17g-3).

**Exhibit 12**. Provide in this Exhibit the following information, as applicable, and which is not required to be audited, regarding the Applicant's aggregate revenues for the fiscal or calendar year ending immediately before the date of the initial application:

- Revenue from determining and maintaining credit ratings;
- Revenue from subscribers;
- Revenue from granting licenses or rights to publish credit ratings; and
- Revenue from all other services and products offered by your credit rating organization (include descriptions of any major sources of revenue).

An NRSRO is not required to make this Exhibit publicly available on its corporate Internet website, pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law. (Note: After registration, Exhibit 12 should not be updated with the filing of the annual certification. Instead, similar information must be filed with the Commission not more than 90 days after the end of each fiscal year pursuant to Exchange Act Rule 17g-3).

**Exhibit 13.** Provide in this Exhibit the approximate total and median annual compensation of the Applicant's credit analysts for the fiscal or calendar year ending immediately before the date of this initial application. In calculating total and median annual compensation, the Applicant may exclude deferred compensation, provided such exclusion is noted in the Exhibit.

An NRSRO is not required to make this Exhibit publicly available on its corporate Internet website pursuant to Exchange Act Rule 17g-1(i). An NRSRO may request that the Commission keep this Exhibit confidential by marking each page "Confidential Treatment" and complying with Commission rules governing confidential treatment (See 17 CFR 200.80 and 17 CFR 200.83). The Commission will keep the information and documents in the Exhibit confidential upon request to the extent permitted by law. (Note: After registration, Exhibit 13 should not be updated with the filing of the annual certification. Instead, similar information must be filed with the Commission not more than 90 days after the end of each fiscal year pursuant to Exchange Act Rule 17g-3).

I. EXPLANATION OF TERMS.

1. COMMISSION - The U. S. Securities and Exchange Commission.

2. CREDIT RATING [Section 3(a)(60) of the Exchange Act] - An assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.

3. CREDIT RATING AGENCY [Section 3(a)(61) of the Exchange Act] - Any person:

   - 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;
   - employing either a quantitative or qualitative model, or both to determine credit ratings; and
   - receiving fees from either issuers, investors, other market participants, or a combination thereof.

4. NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION [Section 3(a)(62) of the Exchange Act] - A credit rating agency that:

   - issues credit ratings certified by qualified institutional buyers in accordance with section 15(a)(1)(B)(ix) of the Exchange Act with respect to:
     - financial institutions, brokers, or dealers;
     - insurance companies;
     - corporate issuers;

   - o issuers of asset-backed securities;
   - o issuers of government securities, municipal securities, or securities issued by a foreign government; or
   - o a combination of one or more of the above; and
- is registered as an NRSRO.

6. PERSON - An individual, partnership, corporation, trust, company, limited liability company, or other organization (including a separately identifiable department or division).

7. PERSON WITHIN AN APPLICANT/NRSRO – The person filing or furnishing, as applicable, Form NRSRO identified in Item 1, any credit rating affiliates identified in Item 3, and any partner, officer, director, branch manager, or employee of the person or the credit rating affiliates (or any person occupying a similar status or performing similar functions).

8. SEPARATELY IDENTIFIABLE DEPARTMENT OR DIVISION - A unit of a corporation or company:

- that is under the direct supervision of an officer or officers designated by the board of directors of the corporation as responsible for the day-to-day conduct of the corporation's credit rating activities for one or more affiliates, including the supervision of all employees engaged in the performance of such activities; and
- for which all of the records relating to its credit rating activities are separately created or maintained in or extractable from such unit's own facilities or the facilities of the corporation, and such records are so maintained or otherwise accessible as to permit independent examination and enforcement by the Commission of the Exchange Act and rules and regulations promulgated thereunder.

8. QUALIFIED INSTITUTIONAL BUYER [Section 3(a)(64) of the Exchange Act] - An entity listed in 17 CFR 230.144A(a) that is not affiliated with the credit rating agency.

19. Section 249b.400 and Form ABS Due Diligence-15E are added to read as follows:

**§249b.400 Form ABS Due Diligence-15E, Certification of third-party provider of due diligence services for asset-backed securities**

**Note: The text of Form ABS Due Diligence-15E will not appear in the Code of Federal Regulations.**

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

## FORM ABS DUE DILIGENCE-15E

## CERTIFICATION OF PROVIDER OF THIRD-PARTY DUE DILGENCE SERVICES FOR ASSET-BACKED SECURITIES

Pursuant 17 CFR 240.17g-10, this Form must be used by a person providing third-party due diligence services in connection with an asset-backed security to comply with Section 15E(s)(4)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7(s)(4)(B)). Section 15E(s)(4)(B) of the Securities Exchange Act of 1934 requires a person providing the due diligence services to provide a written certification to any nationally recognized statistical rating organization that produces a credit rating to which such due diligence services relate.

**Item 1. Identity of the person providing third-party due diligence services**

**Legal Name:**________________________________________

**Business Name (if Different):**________________________________________

**Principal Business Address:**________________________________________

__________________________________________________

**Item 2. Identity of the person who paid the person to provide due diligence services**

**Legal Name:**________________________________________

**Business Name (if Different):**________________________________________

**Principal Business Address:**________________________________________

## Item 3. Credit rating criteria

If the manner and scope of the due diligence performed by the third party satisfied the criteria for due diligence published by a nationally recognized statistical rating organization, identify the nationally recognized statistical rating organization and the title and date of the published criteria (more than one nationally recognized statistical rating organization can be identified).

| Identity of NRSRO | Title and Date of Criteria |
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## Item 4. Description of the due diligence performed

Provide a description of the scope and manner of the due diligence services provided in connection with the review of assets that is sufficiently detailed to provide an understanding of the steps taken in performing the review. Include in the description: (1) the type of assets that were reviewed; (2) the sample size of the assets reviewed; (3) how the sample size was determined and, if applicable, computed; (4) whether the quality or integrity of information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets was reviewed and, if so, how the review was conducted; (5) whether the origination of the assets conformed to stated underwriting or credit extension guidelines, standards, criteria or other requirements was reviewed and, if so, how the review was conducted; (6) whether the value of collateral securing such assets was reviewed and, if so, how the review was conducted; (7) whether the compliance of the originator of the assets with federal, state and local laws and regulations was reviewed and, if so, how the review was conducted; and (8) any other type of review conducted with respect to the assets. This description should be attached to the Form and contain the heading "Item 4." Provide this description regardless of whether the due diligence performed satisfied the criteria for minimum due diligence published by a nationally recognized statistical rating organization.

## Item 5. Summary of findings and conclusions of review

Provide a summary of the findings and conclusions that resulted from the due diligence services that is sufficiently detailed to provide an understanding of the findings and conclusions that were conveyed to the person identified in Item 2. This description should be attached to the Form and contain the heading "Item 5."

## CERTIFICATION

The undersigned has executed this Form ABS Due Diligence 15E on behalf of, and on the authority of, the person identified in Item 1 of the Form. The undersigned, on behalf of the person, represents that the person identified in Item 1 of the Form conducted a thorough review in performing the due diligence described in Item 4 attached to this Form and that the information and statements contained in this Form, including Items 4 and 5 attached to this Form, which are part of this Form, are accurate in all significant respects.

Name of Person Identified in Item 1:________________________________

By:________________________________________________
(Print name of duly authorized person) (Signature)

Date:________________________________________________

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

May 18, 2011

Commissioner Walter
Commissioner Aguilar
not participating

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

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3208 / May 19, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14398**

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| **In the Matter of**<br><br>**JONATHAN HOLLANDER,**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS** |

**I.**

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

**II.**

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

**III.**

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

1. Hollander was, during the relevant time period, an analyst at CR Intrinsic Investors, LLC, an investment adviser and an affiliate of SAC Capital Advisors, LLC. Hollander is currently the CEO of Chesapeake Advisory Group, LLC. Hollander, 35 years old, is a resident of New York, New York.

2. On May 11, 2011, a final judgment ("Final Judgment") was entered by consent against Hollander in the civil action entitled Securities and Exchange Commission v. Jonathan Hollander, Civil Action Number 11-CV-2885, in the United States District Court for the Southern District of New York. The Final Judgment permanently enjoins Hollander from future violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, orders him to pay disgorgement of $95,807, together with prejudgment interest of $31,309. The Final Judgment also orders Hollander to pay a civil penalty of $95,807 pursuant to Section 21A of the Exchange Act.

3. The Commission's complaint alleged, among other things, that Hollander received material nonpublic information from a friend about the impending corporate acquisition of Albertson's, LLC ("ABS"), in January 2006. The Complaint alleged that Hollander, while in possession of the material nonpublic information about the ABS acquisition, traded in ABS securities in his brokerage account, and tipped others, who then traded on the information.

## IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Hollander be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, with the right to reapply for association after three years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64535 / May 23, 2011**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3285 / May 23, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14400**

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| **In the Matter of**<br><br>**JOHN SCULLIN**<br><br>**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 John Scullin pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice[1] against John Scullin ("Scullin" or "Respondent").

## II.

In anticipation of the institution of these proceedings, Scullin 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

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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 … professional … 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.

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, Scullin 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 Scullin's Offer, the Commission finds that:

1. **John Scullin,** age 51, was the Manager for Project Accounting at Baker Energy, Michael Baker Corporation's energy segment, from June 2006 through June 2008. Scullin was never licensed to practice as a certified public accountant ("CPA"), but falsely represented himself to Michael Baker management as a CPA licensed to practice in Virginia.

2. **Michael Baker Corporation** is a Pennsylvania corporation headquartered in Moon Township, Pennsylvania ("Michael Baker" or the "Company"). Michael Baker's business, at the time of conduct at issue, was divided into two business segments: Engineering and Energy. The Engineering division focused on design and consulting services primarily in the United States. The Energy division, Baker Energy, was headquartered in Houston, Texas and focused on the provision of oil related services both in the United States and abroad. Baker Energy typically generated roughly 35-40% of the Company's consolidated gross revenues.

3. On May 11, 2011, the Commission filed a complaint against Scullin in SEC v. Michael Baker Corporation, et al. (Civil Action No. 11-cv-1791). On May 17, 2011, the court entered a final judgment permanently enjoining Scullin, by consent, from future violations of Sections 10(b) and 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 10b-5 and 13b2-1 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-13.

4. In its complaint, the Commission alleged that for the 2006 annual reporting period and the first three quarters of 2007, Scullin, who misrepresented himself as CPA to Michael Baker's management, willfully engaged in improper accounting practices and aided and abetted Michael Baker's fraudulent accounting practices, which resulted in Michael Baker overstating its revenue and net income. As a direct result of Scullin's actions, the Company overstated its consolidated net income by $1.5 million or 15% for 2006 and overstated its consolidated net income by $1.5 million or 94%, $2.4 million or 39%, and $1.9 million or 42%, for the first, second and third quarters of 2007, respectively. The overstatements of revenue and net income were primarily the result of Scullin's improper accounting practices, which he knew or should have known were improper.

IV.

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

Accordingly, it is hereby ORDERED, effective immediately, that Scullin is suspended from appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(3)(i).

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. 64536 / May 23, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14401**

| In the Matter of | ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934 |
|---|---|
| Citizens Capital Corp.,<br>Coho Energy, Inc.,<br>Colonial Industries, Inc.,<br>Comp-U-Check, Inc.,<br>Computer Automation, Inc.,<br>Concentrax, Inc., and<br>Consolidated Capital Properties VII,<br><br>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 Citizens Capital Corp., Coho Energy, Inc., Colonial Industries, Inc., Comp-U-Check, Inc., Computer Automation, Inc., Concentrax, Inc., and Consolidated Capital Properties VII.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Citizens Capital Corp. (CIK No. 925535) is a Texas corporation located in DeSoto, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Citizens Capital is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of over $50,000 for the prior nine months. On March 23, 1992, an involuntary Chapter 7 petition was filed against

Citizens Capital in the U.S. Bankruptcy Court for the Eastern District of New York, which was terminated on June 1, 2000.

2. Coho Energy, Inc. (CIK No. 908797) is a dissolved Texas corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Coho Energy 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. On February 6, 2002, Coho Energy filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Texas, which was terminated on April 3, 2008.

3. Colonial Industries, Inc. (CIK No. 319620) is a Texas corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Colonial Industries is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of over $1,700 for the prior three months. On May 21, 2008, Colonial Industries filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Idaho, which was terminated on September 30, 2009.

4. Comp-U-Check, Inc. (CIK No. 22788) is a revoked Michigan corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Comp-U-Check 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, 1993, which reported a net loss of over $737,000 for the prior three months.

5. Computer Automation, Inc. (CIK No. 22962) is a void Delaware corporation located in Richardson, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Computer Automation 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, 1994, which reported a net loss of $67,000 for the prior three months.

6. Concentrax, Inc. (CIK No. 1136917) is a revoked Nevada corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Concentrax is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2004, which reported a net loss of over $844,000 for the prior three months.

7. Consolidated Capital Properties VII (CIK No. 783321) is a cancelled California limited partnership located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated Capital Properties 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, 1994.

B. DELINQUENT PERIODIC FILINGS

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

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

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

**III.**

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

A. Whether the allegations contained in Section II 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

Chairman Schapiro
Commissioner Paredes
not participating

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64537 / May 23, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14402**

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| **In the Matter of**<br><br>**Columbia Lease Income Fund B LP,**<br>**Commercial Consolidators Corp.,**<br>**Computer Devices, Inc.,**<br>**Coniagas Resources Ltd. (n/k/a Lithium One Inc.),**<br>**Consolidated Health Care Associates, Inc.,**<br>**Consolidated Professor Mines, Ltd., and**<br>**Cornwall Tin & Mining Corp.,**<br><br>**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 Columbia Lease Income Fund B LP, Commercial Consolidators Corp., Computer Devices, Inc., Coniagas Resources Ltd. (n/k/a Lithium One Inc.), Consolidated Health Care Associates, Inc., Consolidated Professor Mines, Ltd., and Cornwall Tin & Mining Corp.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Columbia Lease Income Fund B LP (CIK No. 751684) is a cancelled Delaware limited partnership located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Columbia Lease Income

Fund B 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, 1995.

2. Commercial Consolidators Corp. (CIK No. 1137063) is an Ontario corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Commercial Consolidators is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F/A for the period ended February 28, 2001.

3. Computer Devices, Inc. (CIK No. 311507) is a forfeited Maryland corporation located in Needham, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Computer Devices 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 $127,000 for the prior nine months. On October 31, 1983, Computer Devices filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Massachusetts, which was terminated on November 13, 1989.

4. Coniagas Resources Limited (n/k/a Lithium One Inc.) (CIK No. 894286) is an Ontario corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Coniagas 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, 1999, which reported a net loss of over $2 million for the prior twelve months.

5. Consolidated Health Care Associates, Inc. (CIK No. 752346) is a dissolved Nevada corporation located in Franklin, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated Health Care Associates 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, 1997, which reported a net loss of over $649,000 for the prior three months. On March 15, 2000, Consolidated Health Care Associates filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Massachusetts, which was converted to Chapter 7, and was terminated on June 7, 2010.

6. Consolidated Professor Mines, Ltd. (CIK No. 771965) is an Ontario corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Action Section 12(g). Consolidated Professor Mines is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 1994, which reported a net loss of over $571,000 for the prior twelve months.

7. Cornwall Tin & Mining Corp. (CIK No. 797854) is a void Delaware corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cornwall Tin & Mining is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended August 31, 1995, which reported a net loss of over $4,000 for the prior twelve months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

**III.**

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

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

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

**IV.**

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Casey
Commissioner Paredes
Disapproved

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR PARTS 230 AND 239**

**Release No. 33-9211; File No. S7-21-11**

**RIN 3235-AK97**

# Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** We are proposing amendments to our rules to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 926 requires us to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on the safe harbor from Securities Act registration provided by Rule 506 of Regulation D. The rules must be "substantially similar" to Rule 262, the disqualification provisions of Regulation A under the Securities Act, and must also cover matters enumerated in Section 926 (including certain state regulatory orders and bars).

**DATES:** Comments should be received on or before July 14, 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. Please include File Number S7-21-11 on the subject line; or
- Use the Federal Rulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

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

All submissions should refer to File Number S7-21-11. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Johanna Vega Losert, Special Counsel; Karen C. Wiedemann, Attorney-Fellow; or Gerald J. Laporte, Office Chief, Office of Small Business Policy, at (202) 551-3460, Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

**SUPPLEMENTARY INFORMATION:** We propose to amend Rules 501[1] and 506[2] of Regulation D[3] and Form D[4]under the Securities Act of 1933 ("Securities Act").[5]

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1 17 CFR 230.501.

2 17 CFR 230.506.

3 17 CFR 230.501 through 230.508.

4 17 CFR 239.500.

5 15 U.S.C. 77a *et seq.*

**Table of Contents**

# I. BACKGROUND AND SUMMARY

Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[6] entitled "Disqualifying felons and other 'bad actors' from Regulation D offerings," requires the Commission to adopt rules to disqualify certain securities offerings from reliance on the safe harbor provided by Rule 506 for exemption from registration under Section 4(2) of the Securities Act of 1933. This release proposes amendments to Rules 501 and 506 and Form D to implement Section 926 of the Dodd-Frank Act.

Rule 506 is one of three exemptive rules for limited and private offerings under Regulation D.[7] It is by far the most widely used Regulation D exemption, accounting for an estimated 90-95% of all Regulation D offerings[8] and the overwhelming majority of capital raised in transactions under Regulation D. Rule 506 permits sales of an unlimited dollar amount of securities to be made, without registration, to an unlimited number of accredited investors[9] and up to 35 non-accredited investors, so long as there is no general solicitation, appropriate resale limitations are imposed, any applicable information requirements are satisfied and the other conditions of the rule are met.[10]

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6 Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010) (to be codified at 15 U.S.C. 77d note).

7 The others are Rule 504 and Rule 505, 17 CFR 230.504 and 230.505, which are discussed in notes 100 and 98 below.

8 For the twelve months ended September 30, 2010, the Commission received 17,292 initial filings for offerings under Regulation D, of which 16,027 (approximately 93%) claimed a Rule 506 exemption.

9 Rule 501 of Regulation D lists eight categories of "accredited investor," including entities and natural persons that meet specified income or asset thresholds. *See* 17 CFR 230.501. In a separate rulemaking required by Section 413(a) of the Dodd-Frank Act, the Commission has proposed amendments to the accredited investor standards in our rules under the Securities Act of 1933 to exclude the value of a person's primary residence for purposes of the $1 million accredited investor net worth determination. See Release No. 33-9177 (Jan. 25, 2011) [76 FR 5307] (available at http://www.sec.gov/rules/proposed/2011/33-9177.pdf.)

10 Offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502, including limitations on the manner of offering (no general solicitation), limitations on resale and, if securities are sold to any non-accredited investors, specified information requirements. Where securities are sold only

"Bad actor" disqualification requirements, sometimes called "bad boy" provisions, prohibit issuers and others (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) from participating in exempt securities offerings if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. Rule 506 in its current form does not impose any bad actor disqualification requirements.[11] In addition, because securities sold under Rule 506 are "covered securities" under Section 18(b)(4)(D) of the Securities Act, state-level bad actor disqualification rules do not apply.[12]

In 2007, we proposed a number of amendments to Regulation D, including bad actor disqualification rules that would have applied to all Regulation D offerings (the "2007 Proposal").[13] Although we did not take final action on the 2007 Proposal, we have considered the issues raised and the comments received in respect of the 2007 Proposal in developing the rules we propose today.[14] We have also considered advance comments in letters we have

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to accredited investors, the information requirements do not apply. *See* 17 CFR 230.502 and 230.506. In addition, any non-accredited investors must satisfy the investor sophistication requirements of Rule 506(b)(2)(ii). Offerings under Rule 506 must also comply with the notice of sale requirements of Rule 503. *See* 17 CFR 230.503.

11 Rule 507 of Regulation D imposes a different kind of disqualification specific to Regulation D offerings. Under Rule 507, any person that is subject to a court order, judgment or decree enjoining such person for failure to file the notice of sale on Form D required under Rule 503 is disqualified from relying on Regulation D. 17 CFR 230.507(a). We are not proposing to amend Rule 507 at this time.

12 *See* 15 U.S.C. 77r(b)(4)(D). This provision of Section 18 was added by Section 102(a) of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290,110 Stat. 3416 (Oct. 11, 1996) ("NSMIA"). NSMIA preempts state registration and review requirements for transactions involving "covered securities," including securities offered or sold on a basis exempt from registration under Commission rules or regulations issued under Securities Act Section 4(2). Rule 506 is a safe harbor under Section 4(2).

13 *See* Release No. 33-8828 (Aug. 3, 2007) [72 FR 45116] (available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf.)

14 Comment letters received on the 2007 Proposal are available at http://www.sec.gov/comments/s7-18-07/s71807.shtml.

received to date on this rulemaking project.[15]

Section 926 of the Dodd-Frank Act instructs the Commission to issue disqualification rules for Rule 506 offerings that are "substantially similar" to Rule 262,[16] the bad actor disqualification provisions of Regulation A,[17] and that are also triggered by an expanded list of disqualifying events, including certain actions by state regulators, enumerated in Section 926. The disqualifying events currently covered by Rule 262 include:

- Felony and misdemeanor convictions in connection with the purchase or sale of a security or involving the making of a false filing with the Commission (the same criminal conviction standard as in Section 926 of the Dodd-Frank Act) within the last five years in the case of issuers and ten years in the case of other covered persons;
- Injunctions and court orders within the last five years against engaging in or continuing conduct or practices in connection with the purchase or sale of securities, or involving the making of any false filing with the Commission;
- U.S. Postal Service false representation orders within the last five years;
- Filing, or being or being named as an underwriter in, a registration statement or Regulation A offering statement that is the subject of a proceeding to determine whether

15 To facilitate public input on its Dodd-Frank Act rulemaking before issuance of actual rule proposals, the Commission has provided a series of e-mail links, organized by topic, on its website at http://www.sec.gov/spotlight/regreformcomments.shtml. In this release, we refer to comment letters we received on this rulemaking project in response to this invitation as "advance comment letters." The advance comment letters we received in anticipation of this rule proposal appear under the heading "Adding Disqualification Requirements to Regulation D Offerings," Title IX Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

16 17 CFR 230.262.

17 17 CFR 230.251 through 230.263. Regulation A is a limited offering exemption that permits public offerings of securities not exceeding $5 million in any 12-month period by companies that are not required to file periodic reports with the Commission. Regulation A offerings are required to have an offering circular containing specific mandatory information, which is filed with the Commission and subject to review by the staff of the Division of Corporation Finance.

a stop order should be issued, or as to which a stop order was issued within the last five years; and

- For covered persons other than the issuer:
  - being subject to a Commission order:
    - revoking or suspending their registration as a broker, dealer, municipal securities dealer, or investment adviser;
    - placing limitations on their activities as such;
    - barring them from association with any entity; or
    - barring them from participating in an offering of penny stock; or
  - being suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or national securities association for conduct inconsistent with just and equitable principles of trade.

The disqualifying events specifically required by Section 926 are:

- Final orders issued by state securities, banking, credit union, and insurance regulators, federal banking regulators, and the National Credit Union Administration that either
  - bar a person from association with an entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking, or from savings association or credit union activities; or
  - are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within a ten-year period; and
- Felony and misdemeanor convictions in connection with the purchase or sale of a security or involving the making of a false filing with the Commission.

We are proposing revisions to Rule 506 of Regulation D to implement these requirements. The substance of our proposal is derived from Section 926 of the Dodd-Frank Act and Rule 262. However, the proposed rule has been formatted in a way that is designed to make it easier to understand and apply than current Rule 262. Rule 262 currently provides three different categories of offering participants and related persons, with different disqualification triggers for each category. The amendments we propose would incorporate the substance of Rule 262, but simplify the framework to include one list of potentially disqualified persons and one list of disqualifying events. We propose to codify this in a new paragraph (c) of Rule 506.

To clarify the issuer's obligations under the new rules, we are also proposing a "reasonable care" exception, under which an issuer would not lose the benefit of the Rule 506 safe harbor, despite the existence of a disqualifying event, if it can show that it did not know and, in the exercise of reasonable care, could not have known of the disqualification. To establish reasonable care, the issuer would be expected to conduct a factual inquiry, the nature and extent of which would depend on the facts and circumstances of the situation.

In Part III of this Release, we discuss other possible amendments to our rules to make bad actor disqualification more uniform across other exemptive rules. We are soliciting public comment on these possible amendments, which would go beyond the specific mandates of Section 926. The possible amendments we are considering and on which we are soliciting comment include:

- applying the new bad actor disqualification provisions proposed for Rule 506 offerings uniformly to offerings under Regulation A, Rule 505 of Regulation D and Regulation E (all of which are currently subject to bad actor disqualification under existing Rule 262 or under similar provisions based on that rule) and offerings under Rule 504 of Regulation D (which currently are not subject to federal disqualification provisions); and

- for all disqualifying events that are subject to an express look-back period under current law (*e.g.*, criminal convictions within the last five or ten years, court orders within the last five years), providing a uniform ten-year look back period, to align with the ten-year look-back period required under the Dodd-Frank Act for specified regulatory orders and bars.

Part V of this Release is a chart that compares the provisions of Rule 262, Section 926 of the Dodd-Frank Act and proposed Rule 506(c).

## II. DISCUSSION OF THE PROPOSED AMENDMENTS

### A. Introduction

Section 926(1) of the Dodd-Frank Act requires the Commission to adopt disqualification rules that are substantially similar to Rule 262, the bad actor disqualification provisions applicable to offerings under Regulation A, and that also cover the triggering events specified in Section 926. Accordingly, the rules we are proposing reflect the persons covered by and triggering events specified in those two sources.

### B. Covered Persons

We propose that the disqualification provisions of Rule 506(c) would cover the following, which we sometimes refer to in this release as "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;

- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor.[18]

This generally corresponds to the persons covered by Rule 262, with the changes discussed below.

To clarify the treatment of entities organized as limited liability companies, we propose to cover managing members expressly, just as general partners of partnerships are covered.

To address the types of financial intermediaries likely to be involved in private placements under Rule 506, we are proposing to look to the current standards under Rule 505 of Regulation D rather than to Rule 262 directly. The disqualification provisions of Rule 505 are substantially identical to Rule 262 (and in effect incorporate it by reference), but adapt it to the private placement context. In particular, because Rule 505 transactions do not involve traditional underwritten public offerings but may involve the use of compensated placement agents and finders, Rule 505 substitutes "any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers" for the "underwriters" that are covered by Rule 262.[19] Since Rule 506 transactions, like transactions under Rule 505, would not involve traditional underwritten public offerings but may involve the use of compensated placement

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18 *See* Proposed Rule 506(c)(1).

19 This is achieved by applying the Rule 262 disqualification standards but redefining the term "underwriter," for purposes of Rule 505, to mean "any person that has been or will be paid (directly or indirectly) remuneration for the solicitation of purchasers." Rule 505(b)(iii)(B), 17 CFR 230.505(b)(iii)(B). *See* Proposed Rule 506(c)(1).

agents and finders, we propose to include the current Rule 505 standard described above in the proposed new rule.[20]

We also propose to incorporate and clarify the applicability of the second sentence of current Rule 262(a)(5), under which events relating to certain affiliated issuers are not disqualifying if they pre-date the affiliate relationship.[21] Under the existing rule, orders, judgments and decrees entered against affiliated issuers before the affiliation arose do not disqualify an offering if the affiliated issuer is not (i) in control of the issuer or (ii) under common control, together with the issuer, by a third party that controlled the affiliated issuer at the time such order, judgment or decree was entered. The proposed rule would clarify that this exclusion applies to all potentially disqualifying events that pre-date the affiliation.[22] We believe this is appropriate because the current placement of this language within paragraph (5) of Rule 262 may incorrectly suggest that it applies only to Postal Service false representation orders.

Given the legislative mandate to develop rules "substantially similar" to current Rule 262, however, we are not proposing to make other changes in the classes of persons that would be covered by the new disqualification rules. For example, we are proposing that

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20 The current disqualification provisions of Rule 505 apply to any "partner, director or officer" of a compensated solicitor. We propose to incorporate the references to directors and officers, add a reference to managing members and modify the reference to include only general partners. When the current rules were adopted, financial intermediaries were often structured as general partnerships and the possibility of their having limited partners may not have been considered. We see no policy basis for imposing disqualification on a partnership based on violations of law by its limited partners, and accordingly propose to clarify that only general partners would be covered.

21 The sentence provides: "The entry of an order, judgment or decree against any affiliated entity before the affiliation with the issuer arose, if the affiliated entity is not in control of the issuer and if the affiliated entity and the issuer are not under common control of a third party who was in control of the affiliated entity at the time of such entry does not come within the purview of this paragraph (a) of this section." 17 CFR 230.262(a)(5).

22 *See* Proposed Rule 506(c)(3).

beneficial owners of 10% of any class of an issuer's equity securities would be covered,[23] as they are under current Rule 262, rather than 20% holders, as in the 2007 Proposal.[24] For the same reason, we are proposing that all the officers of issuers and compensated solicitors of investors be covered, as provided in current rules, rather than only executive officers, as provided in the 2007 Proposal.[25]

With the extension of bad actor disqualifications to Rule 506 offerings, we are, however, concerned that continued use of the term "officer" may present significant challenges, particularly as applied to financial intermediaries. The term "officer" is defined under Securities Act Rule 405 to include "a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization."[26] Financial institutions that are acting as placement agents may have large numbers of employees that would come within this definition, many of whom would not have any involvement with any particular offering, but all of whom would be covered persons for purposes of disqualification. Issuers could potentially devote substantial amounts of time and incur significant costs in making factual inquiries.[27] Accordingly, we are requesting comment on whether disqualification should be reserved for executive officers[28]—those performing policy-making functions for a covered person—whether

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23 *See* Proposed Rule 506(c)(1) *and* 17 CFR 230.262(b).

24 *See* 2007 Proposal.

25 *See* 2007 Proposal, Proposed Rule 506(c)(1).

26 17 CFR 230.405.

27 While some types of disqualifying events are readily ascertainable from public records, others are not. *See* note 81 and accompanying text.

28 The term "executive officer" is defined in Rule 501(f) of Regulation D (and in Rule 405) to mean a company's "president, any vice president . . . in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions." 17 CFR 230.501(f), 230.405.

disqualification should apply only to officers actually involved with the offering or limited in some other way, or whether using the same broad category employed in the existing rules would be justified because it would provide a greater degree of investor protection.

We are also not proposing to cover the investment advisers of issuers, or the directors, officers, general partners, or managing members of such investment advisers. These persons are not currently covered under Rule 262 of Regulation A. However, a significant percentage of issuers in Rule 506 offerings are funds,[29] and in many fund structures, the investment adviser and the individuals that control it are the real decision-makers for the fund. For that reason, it may be appropriate for investment advisers and their directors, officers, general partners and managing members to be covered by the bad actor disqualification provisions of Rule 506, at least for issuers that identify themselves as "pooled investment funds" in Item 4 of Form D, or that are registered as investment companies under the Investment Company Act of 1940,[30] are "private funds" as defined in Section 202(a)(29) of the Investment Advisers Act of 1940[31] or that elect to be regulated as "business development companies" (or "BDCs"),[32] and perhaps for other types of issuers.

**Request for Comment**

(1) Is it appropriate to apply the provisions of Section 926 of the Dodd-Frank Act to all of the persons covered under existing Rule 262, as proposed? Should other categories of

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29 For the twelve months ended September 30, 2010, approximately 24% of issuers in transactions claiming a Rule 506 exemption described themselves as "pooled investment funds."

30 15 U.S.C. 80a-1 through 80a-52.

31 A "private fund" is defined as "an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act."

32 A BDC is a closed-end investment company that has elected to be subject to Sections 55 through 65 of the Investment Company Act and that is operated for the purpose of investing in and making significant managerial assistance available to certain types of companies. *See* Investment Company Act § 2(a)(48), 15 U.S.C. 80a-2(48) *and* note 99.

persons be included?

(2) Should we exclude any of the proposed covered persons for purposes of disqualification? If so, please explain why such persons should not subject an offering to disqualification, providing as much factual support for your views as possible.

(3) Is it appropriate to include the managing members of limited liability companies for purposes of disqualification in Rule 506(c), as proposed?

(4) Is the proposed coverage of 10% shareholders (which mirrors current rules) appropriate? Or should our disqualification provisions cover only persons that actually control the issuer (or that hold a larger percentage of its equity)? Should we increase the threshold share ownership for covered persons to 20%, or to some other threshold of ownership (*e.g.*, 25% or a majority)? If we adopted a requirement based on actual control, would issuers be able to easily determine which shareholders were within the scope of the rule?[33] Should the requirements be different for privately-held companies as opposed to companies whose stock trades in the public markets? If so, should the ownership thresholds be higher or lower for private companies as compared to public companies?

(5) We intend that the terms used in the proposed rules would have the meanings provided in Rule 405. Would it be helpful to incorporate the relevant definitions as part of the rules?

(6) Is it appropriate, as proposed, to provide an exception from disqualification for events relating to certain affiliates that occurred before the affiliation arose, based on the current standard set forth in Rule 262(a)(5)?

(7) Should we replace the reference to "officers," which is based on current Rule 262, with a

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33 We would look to the definition of "control" contained in Securities Act Rule 405, *id.*

reference to "executive officers" (using the definition provided in Rule 501(f)[34]), at least as it applies to covered persons other than the issuer? In many organizations, titular officers such as vice presidents may not play an executive or policy-making role. Would it be more appropriate to limit coverage to individuals with policy-making responsibilities, as would result from using the term "executive officer"?

(8) Alternatively, with respect to officers of covered persons other than the issuer, should we limit coverage to those who are actually involved with or devote time to the relevant offering, or to some other specified subgroup of officers—perhaps together with executive officers?

(9) Would it be appropriate to expand the coverage of our rule to include investment advisers and their directors, officers, general partners, and managing members? If we were to do so, should such an extension apply only for particular types of issuers, such as those that identify themselves as "pooled investment funds" on Form D, or for registered "investment companies," "private funds" and BDCs? Or should it apply for all issuers?

## C. Disqualifying Events

After covered persons, the other critical element of bad actor disqualification is the list of events and circumstances that give rise to disqualification. In this regard, our proposal would implement the Dodd-Frank Act requirement that our rules be substantially similar to existing Regulation A and also include the specific events listed in Section 926(2) of the Dodd-Frank Act.

The proposed rule would include the following types of disqualifying events:

- Criminal convictions;
- Court injunctions and restraining orders;

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[34] 17 CFR 230.501(f). The same definition appears in Rule 405.

- Final orders of certain state regulators (such as state securities, banking and insurance regulators) and federal regulators;
- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
- Suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization;
- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

We discuss each of these in turn below.

**1. Criminal convictions.** Section 926(2)(B) of the Dodd-Frank Act provides for disqualification if any covered person "has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission." This essentially mirrors the language of current Rule 262(a)(3), covering criminal convictions of issuers, and Rule 262(b)(1), covering criminal convictions of other covered persons. Section 926(2)(B) differs from Rule 262, however, in two ways.

First, unlike Rule 262(b)(1), Section 926(2)(B) does not address criminal convictions "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser." We are not aware of any legislative history that explains why this type of conviction was not mentioned in Section 926(2)(B). However, because such convictions are covered in existing Rule 262, we believe that rules "substantially similar" to the existing rules should cover them. Accordingly, the proposed revision to Rule 506 would cover such convictions, and would add a reference to convictions arising out of the conduct of the business of a person compensated for soliciting purchasers, as provided in current Rule 505(b)(2)(iii).[35]

Second, Section 926(2)(B) does not include any express time limit on convictions that trigger disqualification. By contrast, Rule 262 provides a five-year look-back for criminal convictions of issuers and a ten-year look-back for criminal convictions of other covered persons (*i.e.*, only convictions handed down within the preceding five or ten years count, and older convictions are no longer disqualifying).[36] There currently are time limits on criminal convictions, as with other disqualifications, and we are therefore proposing the same five-year and ten-year look-back periods that apply under current Rule 262. We are soliciting comment on whether a longer, or permanent, look-back period would be appropriate for either issuers or other covered persons.

We are also soliciting comment on whether there are circumstances in which the rules for disqualification of entities should focus on the beneficial owners and management of such entities at the time of the disqualifying event, rather than the legal entities themselves, and provide for different treatment of entities that have undergone a change of control since the occurrence of the disqualifying event. This would be a broader application of the principle underlying existing Rule 262(a)(5) (reflected in the proposal in Rule 506(c)(3), discussed above), under which events relating to certain affiliates are not disqualifying if they pre-date the affiliate relationship.

For purposes of establishing the relevant look-back periods, we propose to measure from the date of the sale for which exemption is sought. Rule 262 of Regulation A currently measures

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35 *See* Proposed Rule 506(c)(1)(i).

36 The look-back period is to the date of the conviction, not to the date of the conduct that led to the conviction. This is similarly the case with the other look-back periods discussed below; the measurement date is the date of the relevant order or other sanction, not the date of the conduct that was the subject of the sanction.

from the date of the requisite filing with the Commission, which occurs before any offer of securities can be made under that exemption. This approach is not appropriate for Rule 506 offerings because no filing is required to be made with the Commission before an offer or sale is made in reliance on Regulation D.[37] Current Rule 505, which effectively applies Rule 262 in a Regulation D context, addresses this issue by substituting "the first sale of securities under this section" for the Rule 262 reference to filing a document with the Commission.[38] For purposes of Rule 506, we are proposing to refer to the date of the relevant sale, rather than the date of first sale, because we believe it creates a more appropriate look-back period for offerings that may continue for more than one year. Multiyear offerings are not uncommon under Rule 506.[39]

**Request for Comment**

(10) Are the proposed look-back periods for criminal convictions (five years for issuers, their predecessors and affiliated issuers; ten years for all other covered persons) appropriate? Or should we provide for a longer period? Should the look-back period for convictions be aligned with the ten-year look-back period required in some instances under Section 926 of the Dodd-Frank Act?

(11) Are there circumstances where a longer period of disqualification, even lifetime disqualification for individuals or permanent disqualification for entities, would be appropriate?

(12) Should our rules provide different disqualification periods for individuals and entities? In particular, should we provide different treatment under our rules (*e.g.*, a shorter look-back

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37 Under Rule 503, a notice on Form D is not required to be filed until 15 days after the first sale. 17 CFR 230.503.

38 *See* 17 CFR 230.505(b)(2)(iii)(A) *and* 17 CFR 230.602(b)(2).

39 Of the 16,027 initial Form D filings claiming a Rule 506 exemption in the twelve months ended September 30, 2010, 3,812 (or 24%) indicated that the offering was expected to last more than a year.

period or an exception from disqualification) for entities that have undergone a change of control since the occurrence of a disqualifying event? If so, how should change of control be defined for these purposes?

(13) Is the scope of the proposed provisions on criminal convictions sufficiently broad? In connection with the 2007 Proposal[40] and in an advance comment letter on this rulemaking,[41] the North American Securities Administrators Association ("NASAA") has urged that, in the interest of investor protection and uniformity with state laws, disqualification should apply to a broader range of criminal convictions. NASAA suggested that disqualification should arise from any criminal conviction involving fraud or deceit, as provided in the Model Accredited Investor Exemption and the Uniform Securities Act of 2002 adopted by many states, as well as "the making of a false filing with a state, or involving a commodity future or option contract, or any aspect of a business involving securities, commodities, investments, franchises, insurance, banking or finance."[42] Would it be appropriate for the new rules to impose disqualification for some or all of these other offenses, even though Section 926 of the Dodd-Frank Act does not require it?

(14) Under current rules and under our proposal, disqualification arises only from actions taken by U.S.-based courts and regulators. From the standpoint of disqualification, is conduct outside the United States as relevant as conduct within the United States? Should corresponding convictions in foreign courts trigger disqualification on the same basis as

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40 *See* NASAA Comment Letter (Oct. 26, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-57.pdf).

41 *See* NASAA Advance Comment Letter (Nov. 4, 2010) (available at http://www.sec.gov/comments/df-title-ix/regulation-d-disqualification/regulationddisqualification-1.pdf).

42 *See* Unif. Sec. Act § 508 (amended 2002) (available at http://www.abanet.org/buslaw/newsletter/0009/materials/uniformsecure.pdf).

U.S. criminal convictions? Or are there reasons not to treat foreign criminal convictions on a par with U.S. federal or state criminal convictions? What would be the impact on issuers and covered persons if the Commission included foreign court convictions as a disqualifying event under the proposed disqualification provision?

**2. Court injunctions and restraining orders.** Under current Rule 262(a)(4), an issuer is disqualified from reliance on Regulation A if it, or any predecessor or affiliated issuer, is subject to a court injunction or restraining order against engaging in or continuing any conduct or practice in connection with the purchase or sale of securities or involving the making of a false filing with the Commission.[43] Similarly, under current Rule 262(b)(2), an offering is disqualified if any other covered person is subject to such a court injunction or restraining order, or to one "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser."[44] Disqualification is triggered by temporary or preliminary injunctions and restraining orders that are currently in effect, and by permanent injunctions and restraining orders entered within the last five years.[45]

The proposed provision would reflect the substance of these two provisions in a slightly simplified format.[46] To align with current Rule 505, the proposed rule would cover orders arising out of the conduct of business of paid solicitors of purchasers of securities.

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43 *See* 17 CFR 230.262(a)(4).

44 17 CFR 230.262(b)(2).

45 The look-back period means that disqualification no longer arises from an injunction or restraining order after the requisite amount of time has passed, even though the injunction or order is still in effect. Because disqualification is triggered only when a person "is subject to" a relevant injunction or order, injunctions and orders that have expired or are otherwise no longer in effect are not disqualifying, even if they were issued within the relevant look-back period.

46 *See* Proposed Rule 506(c)(1)(ii).

**Request for Comment**

(15) We note that certain regulatory orders and bars are required to have a ten-year look-back period under Section 926(2)(a)(ii) of the Dodd-Frank Act (discussed below). Is it appropriate to limit the look-back period for court injunctions and restraining orders to five years, as proposed, based on current Rule 262? Or should we adopt a ten-year look-back period for injunctions and restraining orders? Should any disqualifying events, criminal and otherwise, result in permanent disqualification from participating in Rule 506 offerings?

(16) Alternatively, should we establish different look-back periods for different types of court orders and injunctions and restraining orders? For example, should we provide for a ten-year look-back for court injunctions and restraining orders involving fraudulent, manipulative or deceptive conduct, and a five-year look-back period for other court injunctions and restraining orders? If we did this, would it be easy to determine which category applied to a given court injunction or order? Should we provide different look-back periods for federal and state court injunctions and restraining orders?

(17) Under current rules and under our proposal, a court injunction or restraining order issued more than five years before the relevant sale is no longer disqualifying, even if it is still in effect. Is it appropriate that court injunctions and restraining orders should cease to be disqualifying after a stated time, as proposed, or should disqualification continue for as long as the triggering injunction or order continues in effect (even if it is permanent)?

(18) Under our proposal, disqualification for court injunctions and restraining orders would be narrower in scope and would have a shorter look-back period than disqualification for

regulatory orders (discussed in C.3 below).[47] The treatment of court injunctions and restraining orders would reflect the position under current rules, while the treatment of regulatory orders is mandated by Section 926 of the Dodd-Frank Act. Should the two provisions be conformed? Or are there policy or other reasons that support differentiating between them?

(19) Should injunctions and orders of foreign courts have no consequences for disqualification, as proposed? Or should they trigger disqualification on the same basis as U.S. federal and state court injunctions and orders, or on some other basis? Why? Should foreign court injunctions and orders have to meet additional criteria to be considered for disqualification purposes? If so, what should those criteria be?

**3. Final orders of certain regulators.** Section 926(2)(A) of the Dodd-Frank Act provides that Commission rules for Rule 506 offerings must disqualify any covered person that

> A) is subject to a final order of a State securities commission (or an agency or officer of a State performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or an agency or officer of a State performing like functions), an appropriate Federal banking agency, or the National Credit Union Administration, that—
> (i) bars the person from—
> (I) association with an entity regulated by such commission, authority, agency, or officer;
> (II) engaging in the business of securities, insurance, or banking; or
> (III) engaging in savings association or credit union activities; or

47 For example, under the proposal and current Rule 262, court injunctions and restraining orders are disqualifying only if they relate to conduct or practices (i) in connection with the purchase or sale of a security, (ii) involving making a false filing with the Commission or (iii) arising out of the conduct of certain businesses. The proposed provisions for regulatory orders, discussed below, are broader, and would impose disqualification for any final order based on a violation of law that prohibits fraudulent, manipulative or deceptive conduct. As a result, under the proposal certain types of orders (*e.g.*, a ban on serving as an officer or director of a public company) would be disqualifying if issued by a regulator but may not be disqualifying if issued by a court.

> (ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of filing of the offer or sale.

Section 926(2)(A) is identical to Section 15(b)(4)(H) of the Securities Exchange Act of 1934 (the "Exchange Act")[48] and Section 203(e)(9) of the Investment Advisers Act of 1940 (the "Advisers Act),[49]except that Section 926(2)(A)(ii) contains a ten-year look-back period for final orders based on violations of statutes that prohibit fraudulent, manipulative and deceptive conduct, and the Exchange Act and Advisers Act provisions have no express time limit for such orders. These existing provisions form a basis on which the Commission may censure, suspend or revoke the registration of brokers, dealers and investment advisers based on financial industry bars and final regulatory orders issued against them by specified regulators, in the context of statutory provisions that provide for such sanctions based on a wide variety of other events.[50]

We propose to codify Section 926(2)(A) almost verbatim as new paragraph (c)(1)(iii) of Rule 506, with clarifying changes intended to eliminate potential ambiguities and make the new rule easier to apply.

With respect to bars, the proposed rule would provide that the order must bar the person "at the time of [the] sale" from one or more of the specified activities. This would clarify that a

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48 15 U.S.C. 78*o*(b)(4)(H).

49 15 U.S.C. 80b(e)(9).

50 For example, Section 15(b)(4) authorizes the Commission to sanction registered brokers and dealers for such matters as false statements in Commission filings; certain U.S. or foreign criminal convictions; certain court injunctions, willful violations of the securities laws or the Commodity Exchange Act, or the rules and regulations issued thereunder; aiding, abetting, counseling or procuring such a violation or failing adequately to supervise someone who committed such a violation; and professional bars issued by the Commission or non-U.S. financial regulatory authorities. *See* 15 U.S.C. 78*o*(b)(4). Section 203(f) authorizes the Commission to sanction registered investment advisers for similar matters. *See* 15 U.S.C. 80b-3(f).

bar is disqualifying only for as long as it has continuing effect.[51] Thus, for example, a person who was barred by a state regulator from association with a broker-dealer for three years would be disqualified for three years. A person who was barred indefinitely, with the right to apply to reassociate after three years, would be disqualified until such time as he or she successfully applied to reassociate, assuming that the bar had no continuing effect after reassociation. (This would be true even if the bar order were also a "final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct," as contemplated by Dodd-Frank Section 926(2)(A)(ii), because the person would not be considered to be "subject to" an order that had no continuing effect.)

Also, recognizing that no Commission filing is required in a Regulation D offering before an offer or sale, we propose to measure the ten-year period required under 926(2)(A)(ii) from the date of the relevant sale, as would be the case for other look-back periods in the proposed rule. Finally, we propose to clarify that the orders described in Section 926(2)(A)(ii) must have been "entered" within the relevant ten-year period, so it is clear that we are measuring from the date of the order and not the date of the underlying conduct.

**Request for Comment**

(20) Should the rules clarify what constitutes a "bar"? For example, should the rule state that all orders that have the practical effect of a bar (prohibiting a person from engaging in a particular activity) be treated as bars, even if the relevant order is not called a bar?

(21) Under current interpretations of Rule 262, bars are disqualifying for as long as they have

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51 This accords with the Commission's current interpretive position on Rule 262. *See* Release No. 33-6289 (Feb. 13, 1981) [46 FR 13505, 13506 (Feb. 23, 1981)] (Commission consistently has taken the position that a person is "subject to" an order under section 15(b), 15B(a) or (c) of the Exchange Act or section 203(e) or (f) of the Investment Advisers Act only so long as some act is being performed (or not performed) pursuant to the order).

continuing effect, which means that permanent bars (for example, an "unqualified" bar, which does not contain any proviso for re-application after a specified period) are permanently disqualifying. By contrast, most other disqualifying events operate only for a specified period (for example, criminal convictions give rise to a disqualification period of five or ten years). Would it be appropriate to provide a cut-off date (for example, ten years), for permanent bars?[52]

Final Orders. The Dodd-Frank Act does not specify what should be deemed to constitute a "final order" that triggers disqualification. The term "final" suggests that only orders issued at the conclusion of a matter should be considered, but beyond that, it is not clear whether other procedural or substantive criteria should be applied.

As noted above, Section 15(b)(4)(H) of the Exchange Act and Section 203(e)(9) of the Advisers Act contain language identical to Section 926(2)(A), including the use of the term "final order." The Commission has not provided a definitive interpretation of "final order" in those contexts either, although it has approved forms for broker-dealers and their associated persons that include such a definition.[53] For purposes of registration of broker-dealers and associated persons, the Financial Industry Regulatory Authority ("FINRA") collects data regarding disciplinary actions, including relevant final orders, through its uniform registration

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52 If we established such a cut-off date, persons subject to a permanent bar would still be prevented from engaging in the barred conduct. (Someone permanently barred from the securities industry would still not be permitted to act as a placement agent, for example.) The difference would be that their presence or participation in an offering in some otherwise permissible capacity—as, for example, a 10% shareholder of the issuer—would not be disqualifying.

53 *See* Release Nos. 34-48161 (Jul. 10, 2003) [68 FR 42444] (available at http://www.sec.gov/rules/sro/nasd/34-48161.pdf) and 34-49779 (May 27, 2004) [69 FR 32084] (available at http://www.sec.gov/rules/sro/nyse/34-49779.pdf).

Forms BD, U4, U5 and U6.[54] In that context, FINRA has defined "final order" to mean "a written directive or declaratory statement issued by an appropriate federal or state agency . . . pursuant to applicable statutory authority and procedures, that constitutes a final disposition or action by that federal or state agency."[55]

We also understand that at least some state securities laws may provide that orders do not become "final" unless the state securities administrator makes findings of fact and conclusions of law on a record in accordance with the state administrative procedure act and files a certified copy of the findings with a clerk of a court of competent jurisdiction, as provided in the Uniform Securities Act of 2002.[56] We are not aware that the laws covering orders of federal and state banking, insurance, and credit union regulators, which are required to be covered in our Rule 506 disqualification rules by the Dodd-Frank Act, provide guidance on which of their orders should be regarded as "final orders."

Our preliminary view is that including a definition of "final order" in the rule would help issuers and other market participants determine whether any given regulatory action is disqualifying (and conversely, not including a definition could give rise to uncertainty in that regard). We are therefore proposing to amend Rule 501 of Regulation D to add a definition of

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54 Form BD is the Uniform Application for Broker-Dealer Registration, used by entities to register as broker-dealers. Form U4 is the Uniform Application for Securities Industry Registration or Transfer, used by broker-dealers to register associated persons. Form U5 is the Uniform Termination Notice for Securities Industry Registration, used by broker-dealers to report the termination of an associated person relationship. Form U6 is the Uniform Disciplinary Action Reporting Form, used by SROs and state and federal regulators to report disciplinary actions against broker-dealers and associated persons. Information on disciplinary history collected via these forms (as well as other information) can be reviewed through BrokerCheck. *See* note 81 for more information about BrokerCheck.

55 *See* "Explanation of Terms" applicable to FINRA Forms U4, U5 and U6 (available at http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p116979.pdf).

56 *See* Unif. Sec. Act § 604 (2002).

"final order" for purposes of bad actor disqualification.[57] The proposed definition is based on the FINRA definition, and therefore is consistent with current practices implementing statutory language in the Exchange Act that is identical to Section 926. We believe that this definition is sufficiently broad to cover the different types of regulatory orders that might be relevant, but we are soliciting comment on that question.

The proposal defines "final order" to mean the final steps taken by a regulator. In at least some cases, however, judicial appeal of a regulatory order will be available. It may be appropriate for us to define "final order" to mean an order for which all rights of appeal have terminated or been exhausted. Given that the appeals process could take several years, however, we are concerned that such an approach could compromise investor protection. We are soliciting comment on whether and how to address rights of judicial appeal. We are also soliciting comment more generally on whether it is appropriate to include a definition of "final order" in the rule.

**Request for Comment**

(22) Is it appropriate, as proposed, to define the term "final order" for purposes of our disqualification rules? What general effects would a defined term or lack of a defined term impose on issuers and other covered persons?

(23) Is the proposed definition of "final order" (which is based on the FINRA definition) appropriate?

(24) Should we use a definition based on the Uniform Securities Act interpretation of final order instead? Alternatively, should we add concepts from that definition (for example, the requirement that the regulator have made findings of fact) to the proposed definition?

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57 *See* Proposed Rule 501.

(25) Should an order be considered final only if it is a "final order" within the meaning of the law that governed its issuance? What if the law lacks clear guidance on what constitutes a final order?

(26) Should we consider an order final if it is the conclusion of an action by the relevant regulator? Or should only non-appealable orders be considered final, so that disqualification would not apply until all appeals, including potential judicial appeals, are exhausted? Would investor protection be compromised if judicial appeals are taken into account?

(27) Should specified minimum criteria apply in determining what constitutes a final order? For example, should we include only orders issued after a proceeding that affords the respondent certain due process rights, such as notice, a right to be heard, and a requirement for a record with written findings of fact and conclusions of law? Should settled matters be treated the same as non-settled matters in this respect?

(28) Should the authority that issues the relevant order be asked to express a view about whether the particular action is a final order for purposes of our disqualification rules? Would such authorities be authorized or be willing to express such a view? Should the Commission defer to the interpretation of the regulator that issued the order to determine whether an order is final?

<u>Fraudulent, manipulative or deceptive conduct</u>. Section 926(2)(A)(ii) of the Dodd-Frank Act provides that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct." We have received advance comment urging us to "differentiate between

technical violations and intentional or other more egregious conduct,"[58] and to impose disqualification only with respect to the latter.

In light of the specificity of the language of Section 926, we are not proposing to include standards or guidance with respect to this requirement. We are aware, however, that any rule we adopt would apply to orders issued by regulators under a wide variety of different state and federal laws and regulations. We understand that there may be concerns that this language could be interpreted or applied very broadly, and in particular that under some state laws and regulations, conduct that some may consider to be a "technical" violation might be defined as fraudulent, manipulative or deceptive.[59] We are, therefore, requesting comment on whether we should set forth minimum standards for this provision.

**Request for Comment**

(29) Should we provide guidance on what constitutes "fraudulent, manipulative or deceptive conduct" for purposes of bad actor disqualification under Rule 506? If so, should we provide such guidance by rule, and what should the rule say?

(30) Should disqualifying conduct be required to be fraudulent, manipulative or deceptive at common law or under some other standard? Should scienter be required?

(31) Should the Commission defer to the regulator that issued the order with respect to the determination of whether conduct is fraudulent, manipulative or deceptive?

(32) Should the authority that issues the relevant order be asked to express a view about

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58 Advance Comment Letter of Managed Funds Ass'n (Sept. 22, 2010) (available at http://www.sec.gov/comments/df-title-iv/exemptions/exemptions-16.pdf).

59 *See* Advance Comment Letter of Investment Program Ass'n (Mar. 2, 2011) (available at http://www.sec.gov/comments/df-title-ix/regulation-d-disqualification/regulationddisqualification-3.pdf). *See also* Record of Proceedings of 29th Annual SEC Government-Business Forum on Small Business Capital Formation, at 18 (Nov. 18, 2010) (remarks of Deborah Froling) (available at http://www.sec.gov/info/smallbus/sbforumtrans-111810.pdf).

whether the particular violation is the sort of violation that should give rise to disqualification under Rule 506? Should the Commission defer to the interpretation of the regulator on that issue? In that connection, should we provide greater scope for a regulator to determine that disqualification should not arise (in effect, a waiver of disqualification)?

Orders of Other Regulators

As mandated by Section 926 of the Dodd-Frank Act, bad actor disqualification would result under our proposed rule from final orders issued within a ten-year period by the state and federal regulators identified in Section 926(2)(A) of the Dodd-Frank Act, a list that does not include the Commission or the Commodity Futures Trading Commission ("CFTC"). We are considering and soliciting comment on whether orders of the Commission and the CFTC should have the same effect for disqualification purposes as the orders of these other regulators.

Some types of orders issued by the Commission are covered by current bad actor disqualification rules, and some are not.[60] Most significantly, orders issued in stand-alone Commission cease-and-desist proceedings[61] are not disqualifying under current rules.[62] The reason for this omission appears to be largely historical: the Commission did not have authority

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60 Certain Commission orders involving regulated entities in the securities industry (*e.g.*, broker-dealers and investment advisers) and their associated persons already give rise to disqualification under Regulation A, Rule 505 and Regulation E as currently in effect. *See* Rule 262(b)(3) and Rule 602(b)(5) and (c)(3), 17 CFR 230.262(b)(5) and 230.602(c)(3).

61 In cease-and-desist proceedings, the Commission can issue orders against "any person," including entities and individuals outside the securities industry, imposing sanctions such as penalties, accounting and disgorgement or officer and director bars. In contrast, administrative proceedings are generally limited to regulated entities and their associated persons.

62 Current rules also exclude other types of Commission actions. For example, the Commission has authority under Section 9(b) of the Investment Company Act to bring proceedings against "any person" and may impose investment company bars, civil penalties and disgorgement under Sections 9(d) and (e) of the Investment Company Act. 15 U.S.C. 80a-9(b), (d) and (e). The Commission also has authority under Rule 102(e) of its Rules of Practice to censure persons (such as accountants and attorneys) who appear or practice before it, or to deny them the privilege of appearing before the Commission temporarily or permanently. 17 CFR 201.102(e). Orders under these sections are not currently disqualifying.

to bring cease-and-desist proceedings when Rule 262 was originally adopted, and the rule has not been amended to take account of that authority.[63] Unless our disqualification rules cover Commission cease-and-desist orders, entities and individuals outside the securities industry would be subject to bad actor disqualification for Commission actions only if those persons are subject to a court order. In the 2007 Proposal, we proposed to include Commission and certain other cease-and-desist orders as disqualifying events in the Regulation D bad actor provisions.[64] Some commenters opposed this proposal on the basis that it would be overinclusive and could result in disqualification being imposed for minor technical violations.[65] We are soliciting comment as to whether Commission cease-and-desist orders may be an appropriate basis for disqualification and, if so, whether the rules should differentiate among different types of orders.

We are also considering whether orders of the CFTC are relevant for disqualification purposes. The CFTC is the only regulator in the financial services area whose orders are not directly addressed by the proposed rules, and the conduct that would typically give rise to CFTC sanctions is similar to the type of conduct that would trigger disqualification if it were the subject of action by a regulator in the securities, insurance, banking or credit union sectors. On that basis, we are soliciting comment as to whether CFTC orders may be an appropriate basis for disqualification.

Our preliminary view is that, if we were to include Commission and CFTC orders in our

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63 The disqualification provisions of Rule 505 and Regulation E are derived from Rule 262 and reflect the same omission.

64 Under the 2007 Proposal, disqualification would have arisen if a covered person "is currently subject to a cease and desist order, entered within the last 5 years, issued under federal or state securities, commodities, investment, insurance, banking or finance laws." *See* Release 33-8828, note 13 above.

65 *See, e.g,* Comment Letter of Managed Funds Association (Oct. 19, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-56.pdf); Comment Letter of G. Philip Rutledge (Oct. 5, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-26.pdf).

bad actor disqualification rules, we would do so by adding references to the Commission, the CFTC and the commodities business in the paragraph of the rules that addresses "final orders" of certain regulators.[66] In that way, any requirements the rule may impose on such orders and any interpretive positions that may apply (for example, on what constitutes a final order and what constitutes fraudulent, manipulative and deceptive conduct) would apply to orders of the Commission and the CFTC on the same basis as it did to orders of state and other federal regulators covered by the rule. We would exclude from this provision Commission disciplinary orders that are already covered under current rules, and continue to treat them separately.[67]

If we were to adopt bad actor disqualification provisions that included orders of the Commission and the CFTC, we would also have to consider the impact on competition, efficiency and capital formation and the impact on small businesses. Our preliminary view is that adding new disqualifying events for Commission and CFTC orders would probably increase the number of offerings that would be disqualified, may enable the disqualification rules to more effectively screen out felons and other bad actors, and would contribute to creating an internally consistent set of rules that would treat relevant sanctions similarly for disqualification purposes. It may result in increased compliance costs for companies and funds that are seeking to raise capital. However, adding Commission and CFTC orders to the new rules could improve investor protection and reduce the risks of investment in private placements and limited offerings, and thereby help to reduce the cost or increase the availability of capital. We do not expect that it would affect small businesses differently than the rules we are proposing.

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66 *See* Proposed Rule 506(c)(1)(iii).

67 *See* Part II.C.4 of this Release and Proposed Rule 506(c)(1)(iv).

**Request for Comment**

(33) Would it be appropriate to include the Commission in the list of regulators whose final orders are potentially disqualifying?

(34) If so, should the rules specify that certain types of Commission cease-and-desist orders would always give rise to disqualification? For example, we could treat cease-and-desist orders related to violations of the anti-fraud provisions of our statutes and rules in this way (or perhaps those that require an element of scienter), by analogy to the Section 926 standard of "fraudulent, manipulative or deceptive conduct." Similarly, we could treat cease-and-desist orders related to violations of Section 5 of the Securities Act in this way, on the basis that persons who violate Section 5 should lose the benefit of exemptive relief from Section 5 for some period of time afterward. Should other categories of orders be expressly covered in this way?

(35) Conversely, should some categories of cease-and-desist orders (for example, those relating to recordkeeping violations) be expressly excluded from coverage by the rule, so they could never give rise to disqualification? If so, what types of orders should be excluded?

(36) Would it be appropriate to include the CFTC in the list of regulators whose final orders are potentially disqualifying? If so, should the rules specify that certain types of CFTC orders would always give rise to disqualification, or that certain types would never give rise to disqualification? If so, what types of orders should be included or excluded?

(37) If we were to cover Commission and CFTC orders in our bad actor disqualification rules, should we do that by simply including references to them in the paragraph that addresses "final orders" of certain regulators? Or should we treat orders of the Commission and/or

the CFTC separately? If so, why?

(38) What would the costs and benefits be of covering Commission and CFTC orders? Would the benefits justify the costs? How would extending our disqualification rules in that way affect competition, efficiency and capital raising? Would small businesses be affected differently than they would be under the rules as proposed and, if so, how?

(39) Are there any other regulators whose final orders should be taken into account for disqualification purposes?

(40) Under the proposal, corresponding orders of foreign securities regulators would not trigger disqualification. Should such orders be disqualifying on the same basis as U.S. federal and state regulatory orders? If so, should the rules refer to any securities regulator or a country's principal securities regulator?

**4. Commission disciplinary orders.** Rule 262(b)(3) of Regulation A imposes disqualification on an issuer if any covered person is subject to an order of the Commission "entered pursuant to section 15(b), 15B(a), or 15B(c) of the Exchange Act, or section 203(e) or (f) of the Investment Advisers Act."[68] Under the cited provisions, the Commission has authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers and investment advisers and their associated persons, including suspension or revocation of registration, censure, placing limitations on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock. The Commission has historically interpreted Rule 262(b)(3) to

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68 17 CFR 230.262(b)(3) (citing 15 U.S.C. 78o(f), 78o(4)(a), 78o(4)(c), 80b-3(e) and 80b-3(f)). Section 21B(a) of the Exchange Act, 15 U.S.C. 78u-2(a), and Section 203(i) of the Investment Advisers Act, 15 U.S.C. 80b-3(i), give the Commission authority to impose civil money penalties in these disciplinary proceedings.

require disqualification only for as long as some act is prohibited or required to be performed pursuant to the order, with the consequence that censures are not disqualifying, and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.[69] We are seeking comment on whether this, as well as certain interpretive positions of the staff of the Division of Corporation Finance, should be codified in the new rule.[70]

We are not proposing substantial changes to the substance of the current rule or its interpretation.[71] In particular, we do not believe that any look-back period is appropriate or should be added, on the basis that the duration of the suspension or limitation on activities imposed by the Commission should be sufficient from an investor protection standpoint.

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69 *See* Release No. 33-6289 (Feb. 13, 1981) [46 FR 13505, 13506 (Feb. 23, 1981)] (in adopting amendments to Rule 252 of Regulation A (the predecessor to Rule 262), the Commission noted "In those instances where persons are subject to orders containing no definite time limitations, the Commission has consistently taken the position that a person is subject to an order only so long as some act is being performed pursuant to such order, [such as] establishing procedures to assure appropriate supervision of salesmen and reporting on such procedures.") The staff of the Division of Corporation Finance has taken the same view. *See* Release No. 33-6455, Question 66 (Mar. 3, 1983) [48 FR 10045, 10053 (Mar. 10, 1983)] (in interpretive release on Regulation D, the staff advised that censure has no continuing force and thus censured person is not "subject to an order of the Commission entered pursuant to section 15(b)" within the meaning of Rule 505); Howard, Prim, Rice, Nemerovski, Canady & Pollak, SEC No-Action Letter, 1975 WL 11300 (Jan. 8, 1975, publicly available Feb. 11, 1975) (Rule 252 does not comprehend a situation where an underwriter of a Regulation A offering has stipulated to a consent order in a Commission administrative proceeding providing only for a censure, with no suspension or other sanction); Samuel Beck, SEC No-Action Letter, 1975 WL 11471 (May 15, 1975, publicly available June 24, 1975).

70 Based on similar reasoning as has been applied to censures, the staff of the Division of Corporation Finance has informally interpreted orders to pay civil money penalties as not disqualifying. We seek comment on whether we should formally codify that position, and also on whether orders to pay money penalties should be disqualifying if the fines are not paid as ordered.

71 Because of our approach of having one list of covered persons and one list of disqualifying events, this provision would have slightly broader reach under the proposal than under current rules. Under current Rule 262(b)(3), disqualification for Commission disciplinary orders applies to covered persons other than issuers and their predecessors and affiliated issuers Under the proposal, all covered persons would be subject to it. For issuers that are (or whose predecessors or affiliated issuers are or were) registered brokers, dealers, municipal securities dealers or investment advisers, the proposal would therefore create a new triggering event for disqualification.

To make the new provisions easier to understand and use, however, we are proposing to simplify the presentation and codify the current interpretation.[72] We are also proposing to eliminate an apparent anomaly in the current rule, whereby orders issued under Section 15B(a) of the Exchange Act (the basic registration requirements for municipal securities dealers) are treated as disqualifying. Section 15B(a) is not generally a source of sanctioning authority and we do not believe it is appropriate to refer to it in the context of bad actor disqualification. Disciplinary orders against municipal securities dealers are issued under Section 15B(c), a reference to which we propose to include in the new disqualification provisions.

**Request for Comment**

(41) Is it appropriate for the new rule to largely codify the current rule, as proposed?

(42) Should we impose any look-back period for Commission disciplinary sanctions?

(43) Should the rules provide that censure is disqualifying? If so, how long should disqualification last?

(44) For orders limiting activities and financial industry bars, should we impose a longer period of disqualification than the period that the order or bar remains in effect? For example, should we impose a look-back period so that anyone who was subject to such an order or bar within the prior five or ten years would be disqualified?

(45) Should the rules provide that orders to pay civil money penalties are disqualifying if the penalties are not paid as ordered? Should such orders be disqualifying in other circumstances?

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72 *See* Proposed Rule 506(c)(1)(iv).

(46) Should the reference to Section 15B(a) in the current rule be eliminated, as proposed, or included? If we include it, should coverage be limited to orders denying registration because of prior misconduct?

**5. Suspension or expulsion from SRO membership or association with an SRO member.** Rule 262(b)(4) imposes disqualification on an offering if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, a securities self-regulatory organization or "SRO" (a registered national securities exchange or national securities association) for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.[73] Again, we are not proposing to change the substance of the current rule (and in particular, are not proposing to add any look-back period).[74] The proposal would update the rule by adding a reference to a registered affiliated securities association.[75]

**Request for Comment**

(47) Should the rule also cover suspension or expulsion from membership or participation in any commodities exchange or commodities self-regulatory organization, or from any other organization?

(48) Should a look-back period be applied?

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73 *See* 17 CFR 230.262(b)(4).

74 The application of this provision is slightly broader under the proposal than under Rule 262(b)(4), in that it would apply to all covered persons, including issuers and their predecessors and affiliated issuers (which are excluded under Rule 262(b)(4)). *See* Proposed Rule 506(c)(1)(v).

75 In 2007, the SEC approved the formation of FINRA, a consolidation of the enforcement arm of the New York Stock Exchange, NYSE Regulation, Inc. and the NASD. Once formed, FINRA became responsible for regulatory oversight of all securities firms that do business with the public. *See* SR-NASD-2007-023, Release No. 34-56145, Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc. (available at http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.) Registered national securities exchanges maintain the right to enforce their own rules.

(49) Should suspension or expulsion from participation in foreign securities exchanges be covered?

**6. Stop orders and orders suspending the Regulation A exemption.** Paragraphs (a)(1) and (2) of Rule 262 impose disqualification on an offering if the issuer, or any predecessor or affiliated issuer, has filed a registration statement or Regulation A offering statement that was the subject of a Commission refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued.[76] In a similar vein, paragraphs (c)(1) and (2) impose disqualification if any underwriter of the securities proposed to be issued was, or was named as, an underwriter of securities under a registration statement or Regulation A offering statement that was the subject of a Commission refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued.[77] We propose to incorporate the substance of these four paragraphs into the rule but simplify the presentation and combine them into a single paragraph that would apply to all covered persons.[78]

**Request for Comment**

(50) Is it appropriate to include the current Regulation A five-year look-back period for these actions? Or should we impose a longer period, such as, for example, ten years?

(51) Should this provision cover comparable actions by commodities regulators or other regulators? If so, what actions, by which regulators, should be covered?

(52) Should this provision cover comparable actions by foreign securities regulators?

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[76] 17 CFR 230.262(a)(1) and (2).

[77] 17 CFR 230.262(c)(1) and (2).

[78] *See* Proposed Rule 506(c)(1)(vi).

**7. U.S. Postal Service false representation orders.** Paragraphs (a)(5) and (b)(5) of Rule 262 impose disqualification on an offering if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail.[79] We propose to incorporate the substance of these paragraphs but combine them into a single paragraph and simplify the presentation to eliminate unnecessary statutory citations. We are proposing to mirror the current five-year look-back period for U.S. Postal Service false representation orders.[80]

(53) Is it appropriate to mirror the current five-year look-back period for U.S. Postal Service false representation orders? Or should we extend the look-back period to ten years to correspond with the ten-year look-back period for regulatory orders under the Dodd Frank Act?

### D. Reasonable Care Exception

Under Section 926 of the Dodd-Frank Act, the events that generally give rise to bad actor disqualification under current rules, plus specified orders issued by a variety of state regulators (including securities, banking, credit union, savings association and insurance regulators) and federal banking and credit union regulators, are required to result in disqualification under Rule 506. Once Section 926 is implemented, a substantially greater number of exempt securities offerings than before will be subject to bad actor disqualification requirements, effectively

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[79] Paragraph (a)(5) relates to issuers and their predecessors and affiliated issuers, and paragraph (b)(5) relates to other covered persons. Disqualification results if any covered person "is subject to a United States Postal Service false representation order entered under 39 U.S.C. § 3005 within 5 years prior to the filing of the offering statement, or is subject to a temporary restraining order or preliminary injunction entered under 39 U.S.C. § 3007 with respect to conduct alleged to have violated 39 U.S.C. § 3005." 17 CFR 230.262(a)(5) and (b)(5).

[80] *See* Proposed Rule 506(c)(1)(vii).

imposing a new burden of inquiry on many issuers with respect to potential disqualifying events.

Although some disqualifying events will be a matter of public record,[81] there is no central repository that aggregates information from all the federal and state courts and regulatory authorities that would be relevant in determining whether a covered person has a disqualifying event in his or her past. In addition, the number of covered persons whose presence or participation could be disqualifying may be quite large, particularly if, as proposed, the rules cover all "officers" of persons compensated for soliciting investors. As noted above, broker-dealers may have large numbers of officers, many of whom would not have any involvement with the offering in question, but all of whom would be covered persons for purposes of disqualification.

Our proposal attempts to address the potential difficulty of ascertaining whether disqualifications apply by including an exception from disqualification for offerings where the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of another covered person.[82] We are proposing a reasonable care exception out of a concern that the benefits of Rule 506—which, among other things, is intended to create a cost-effective method of raising

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81 For example, FINRA maintains BrokerCheck, an online tool that enables the public to check the licensing and securities industry disciplinary history of registered broker-dealers and their associated persons. The information included in BrokerCheck is derived from the Central Registration Depository, the securities industry online registration and licensing database. The staff of the Office of Investor Education and Advocacy has prepared a study, including recommendations, required by Section 919B of the Dodd-Frank Act on ways to improve investors' access to registration information (including disciplinary actions; regulatory, judicial and administrative proceedings; and other information) about broker-dealers, investment advisers and their associated persons. *See* Staff of the Office of Investor Education and Advocacy, Study and Recommendations on Improved Investor Access to Registration Information about Investment Advisers and Broker-Dealers (Jan. 2011) (available at http://www.sec.gov/news/studies/2011/919bstudy.pdf). In addition, FINRA has recently launched its new Disciplinary Actions Online database, which provides access to FINRA complaints against firms and individual brokers, settlement agreements, decisions by FINRA hearing panels and National Adjudicatory Council decisions. BrokerCheck reports will provide links to this new database.

82 *See* Proposed Rule 506(c)(2)(ii).

capital, particularly for small businesses—may otherwise be substantially reduced. Issuers may be reluctant to offer or sell securities in reliance on an exemptive rule if the exemption could later be found, despite the issuer's exercise of reasonable care, not to have been available; the risk of a potential Section 5 violation or blue sky law violation may outweigh the potential benefits of relying on the exemption. On the other hand, issuers must have a responsibility to screen bad actors out of their Rule 506 offerings. We believe that providing a reasonable care exception would help to preserve the intended benefits of Rule 506 and avoid creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.[83]

The language of the proposed exception is based on the standard of the Model Accredited Investor Exemption ("MAIE"), which was approved by NASAA in 1997.[84] We included a similar exception in the 2007 Proposal. Under both the MAIE and our proposed exception, the burden would be on the issuer to establish that it had exercised reasonable care (most likely in the context of an enforcement proceeding brought by a regulator or a private action brought by investors). The MAIE incorporates as part of the standard that reasonable care must be "after factual inquiry." In the 2007 Proposal, we did not include an express reference to "factual

[83] Regulation D already has a provision, Rule 508, under which "insignificant deviations" from the terms, conditions and requirements of Regulation D will not necessarily result in loss of the exemption from Securities Act registration requirements. Rule 508 provides that the exemption will not be lost with respect to any offer or sale to a particular individual or entity as a result of a failure to comply with a term, condition or requirement of Regulation D if the person relying on the exemption shows that: (i) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole (provided that certain Regulation D requirements, including limitations on general solicitation and any applicable limits on the amount of securities offered and the number of investors, are always deemed significant); and (iii) a good faith and reasonable attempt was made to comply. 17 CFR 230.508. We do not believe that Rule 508 would cover circumstances in which an offering was disqualified based on Proposed Rule 506(c).

[84] As of the date of this Release, 31 states plus the District of Columbia had adopted some form of the MAIE. *See* CCH SmartCharts™ Blue Sky Topics, "Did the State Adopt the NASAA Model Accredited Investor Exemption?."

inquiry," but requested comment on whether the rule should require that reasonable care be based on a factual inquiry, as provided in the MAIE. The commenters who responded to this point were generally supportive of a requirement that issuers make an effort to assure themselves that no bad actors are involved with their offerings, but differed on whether an express reference to factual inquiry must be included in the rule itself.[85]

We believe the concept of reasonable care necessarily includes inquiry by the issuer into the relevant facts. Our proposed reasonable care exception, therefore, would include an instruction specifying that reasonable care would entail a factual inquiry, the nature of which would depend on the facts and circumstances.[86]

The steps an issuer should take to exercise reasonable care would vary according to the circumstances of the covered persons and the offering, taking into account such factors as the risk that bad actors could be present, the presence of other screening and compliance mechanisms and the cost and burden of the inquiry. In some circumstances, factual inquiry of the covered persons themselves (for example, by including additional questions in questionnaires issuers may already be using to support disclosures regarding directors, officers and significant shareholders of the issuer) may be adequate. Issuers should also consider whether investigating publicly available databases is reasonable. In some circumstances, further steps may be necessary.

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85 *See* NASAA Comment Letter, note 40. *See also* Comment Letter from Carol Bavousett Mattick, P.C. Chair of the Securities Law Committee, Business Law Section of the State of Texas (Oct. 9, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-36.pdf) (using questionnaires similar to the current practices for establishing a reasonable basis for determining accredited investor status would seem to be appropriate).

86 *See* Proposed Rule 506(c)(2)(ii), where the instruction states: "*Instruction to paragraph (c)(2)(ii)* An issuer will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether any disqualifications exist. The nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants."

**Request for Comment**

(54) Is it appropriate and consistent with investor protection to include a reasonable care exception in our disqualification rules?

(55) What would be the practical effect on issuers and other market participants of not including such an exception?

(56) What steps do issuers typically take to confirm the absence of a disqualification for offerings under current Regulation A and Rule 505 of Regulation D? How would practice norms under the proposed rules applicable to Rule 506 offerings be expected to compare to current norms if a reasonable care exception were introduced?

(57) Is it appropriate to condition the reasonable care exception on factual inquiry? Are there any circumstances in which factual inquiry should not be required? Should the rule specify what factual inquiry is required or provide examples of specific factual inquiries that might be undertaken by the issuer?

(58) With respect to officers of compensated solicitors of investors, in light of the potentially significant volume of inquiries required to determine whether there are disqualifying covered persons associated with a broker-dealer, should the rules provide specific steps to establish reasonable care? If so, what should those steps be?

### E. Waivers

Currently, issuers may seek waivers from disqualification from the Commission under Regulation A.[87] The Commission may grant a waiver if it determines that the issuer has shown good cause "that it is not necessary under the circumstances that the [registration] exemption . . .

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[87] 17 CFR 230.262.

be denied."[88] Consistent with Section 926 and its mandate to the Commission to promulgate disqualification rules "substantially similar" to Regulation A, we propose to carry over the current waiver provisions of Rule 262 to our new disqualification provisions.[89]

**Request for Comment**

(59) Is it appropriate for our bad actor disqualification rules to provide for Commission authority to waive disqualification, as proposed?

(60) Should the Commission exercise waiver authority under its disqualification rules for cases involving final orders of state regulators? Under what circumstances should the Commission exercise that authority? With regard to state regulatory matters, should there be additional requirements (such as concurrence by the relevant regulator or lack of objection after notice) before the Commission should consider issuing a waiver?

(61) Should we provide guidance on circumstances that are likely to give rise to the grant or denial of a waiver?

(62) Should our rules include a provision (such as currently included in the MAIE)[90] that provides an exception from disqualification if the relevant authority of the state to which the disqualification relates waives the disqualification?

## F. Transition Issues

**1. Disqualifying events that pre-date the rule.** Under the proposal, the new

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88 *Id.*

89 *See* Proposed Rule 506(c)(2)(i). Under current rules, the Commission has delegated authority to the Director of the Division of Corporation Finance to grant disqualification waivers under Regulation A. *See* 17 CFR 200.30-1(b). Under the proposal, there would be no delegation of authority for waivers of bad actor disqualification under new Rule 506(c), and all such waivers would have to be issued by a direct order of the Commission itself.

90 *See* NASAA, Model Accredited Investor Exemption (D)(2)(b) (available at http://www.nasaa.org/content/Files/Model_Accredited_Investor_Exemption.pdf).

disqualification provisions would apply to all sales made under Rule 506 after the effective date of the new provisions. (The provisions would not affect any transaction that was completed before the effective date.) Offerings made after the effective date would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back periods, regardless of whether the events occurred before enactment of the Dodd-Frank Act, or the proposal or effectiveness of the amendments to Rule 506. We believe that giving full effect to the bad actor provisions upon adoption carries out Congress' mandate.[91] We nevertheless recognize that application of the new disqualification provisions could affect a number of market participants. We are, therefore, seeking comment on potential approaches to alleviate any concerns about possible unfairness, as explained more fully below.

We believe that, under the text of Section 926 as enacted by Congress, past disqualifying events should be taken into account under our new disqualification rules.[92] Dodd-Frank Act Section 926(2)(A)(i), for example, states that these rules shall disqualify any offering or sale by a person who "is subject" to a final order of a State securities commission or other regulator that bars the person from certain activities. Section 926(2)(A)(ii) similarly requires disqualification of any offering or sale by a person subject to a final State order "that constitutes a final order

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91 Statement of Senator Christopher Dodd, CR S3813 (May 17, 2010).

92 In *Landgraf v. USI Film Products*, 511 U.S. 244 (1994), the Supreme Court set forth a general framework for determining the temporal reach of a statute. The first step in that analysis is determining whether Congress has expressed a clear intent on the statute's proper reach. *See also Fernandez-Vargas v. Gonzales*, 548 U.S. 30, 37 (2006) (in the absence of express language regarding retroactive intent, "we try to draw a comparably firm conclusion about the temporal reach specifically intended by applying 'our normal rules of construction'"). If Congress has done so, that intention controls. If Congress has not expressed a clear intention on how the statute applies to past events, the second step of the *Landgraf* analysis is to determine whether the statute impairs rights a party possessed when he acted, increases liability for past conduct or imposes new duties with respect to transactions already completed. 511 U.S. at 280. However, the fact that a statute's operation draws on antecedent facts or may upset expectations based on prior law does not make it impermissibly retroactive. *Id.* at 269 and n.24. *See also Nat'l Cable & Telecommunications Assn. v. FCC*, 567 F.3d 659, 670 (D.C. Cir. 2009); *Boniface v. U. S. Dept. of Homeland Security*, 613 F.3d 282 (D.C. Cir. 2010); *Empresa Cubana Exportadora de Alimentos y Productos Varios v. U.S. Dept. of the Treasury*,___ F 3d ___, 2011 WL 1120271 (D.C. Cir. 2011).

based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct *within the 10-year period ending on the date of the filing of the offer or sale*" (emphasis added). Section 926(2)(B) requires disqualification of any person who "*has been* convicted" of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission (emphasis added). In each case, the statutory directive states that our rules shall provide for disqualification based on a past event. In addition, Section 926(1) requires the new disqualification rules to be "substantially similar" to the existing disqualification provisions in Rule 262 of Regulation A. That rule currently disqualifies offerings based on past disqualifying events affecting issuers and other covered persons.[93]

In addition, we are mindful that Section 926 replaced a provision in an earlier bill that would have eliminated federal pre-emption of Rule 506 offerings, thus subjecting such offerings to state "blue sky" regulation. Without pre-emption, existing convictions, disciplinary orders and other disqualifying events would have operated to disqualify offerings in the states that have bad actor disqualification rules. Replacing this provision with Section 926 was not seen as decreasing investor protection in this regard,[94] suggesting that Section 926 was intended to take into account pre-existing disqualifying events.

Rule 506 is an exemptive rule that establishes a safe harbor from statutory registration requirements for securities offerings. It does not create rights, so disqualification from participation in that type of exempt offering cannot inappropriately prejudice any person.

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[93] Senator Dodd's statement on the Senate floor, when he proposed adding this language, provides further support. "New section 926 would disqualify felons and other "bad actors" who have violated Federal and State securities laws from continuing to take advantage of the rule 506 private placement process. This will reduce the danger of fraud in private placements." Statement of Sen Dodd, CR S3813 (May 17, 2010)]. It suggests an intention to prevent previous violators from continuing to rely on our exemptions, which can only be accomplished if pre-existing disqualifying events are taken into account.

[94] *See* NASAA letter, dated April 27, 2010, quoted at CR S3813; *see also* letter of the Angel Capital Association, dated April 21, 2010, quoted at CR S3813).

Moreover, offerings that would be disqualified from reliance on Rule 506 under the new provisions could potentially still be effected on a registered basis, pursuant to an available statutory exemption such as Section 4(2) or Section 4(5) of the Securities Act, or pursuant to another exemptive rule. Alternatively, issuers may regain eligibility to rely on Rule 506 if they are able to terminate their relationship with the bad actor whose involvement triggers disqualification.

We are therefore not proposing to exempt, "grandfather," or otherwise make special provision for events that occurred before enactment of the Dodd-Frank Act or the effective date of the proposed amendments. We are soliciting comment, however, about whether the new disqualification provisions required under the Dodd-Frank Act would operate in an unfair manner in particular respects and, if so, how we should address that. For example, should the rules provide a different treatment for persons who entered into negotiated settlements prior to the enactment of the Dodd-Frank Act, the date of this Release or the effective date of our rules, on the basis that they might not have settled on the same terms (or at all) if they had known it would result in disqualification from future Rule 506 offerings? We are soliciting comment on whether we should provide grandfathering or other accommodation for some or all events that predate enactment of the Dodd-Frank Act, this Release or the effective date of our rules, provided such grandfathering or other accommodation would be consistent with the requirements of Section 926. We are also seeking comment on whether we should extend the benefit of waivers previously granted in respect of disqualification from Regulation A, Rule 505 of Regulation D or Regulation E, so that such waivers would cover the new disqualification provisions applicable to Rule 506.

**Request for Comment**

(63) Should the Commission provide for grandfathering of pre-existing disqualifying events, or other phase-in procedures for the new disqualification provisions? What would be the effect on issuers, other covered persons and investors of implementing the new bad actor disqualification provisions without grandfathering, as proposed? Would providing for grandfathering be consistent with the requirements of Section 926 of the Dodd-Frank Act?

(64) If we provide for grandfathering, should we grandfather disqualifying events that occurred before enactment of the Dodd-Frank Act, before the date of this Release or before adoption or effectiveness of the amendments to Rule 506? What impact would that have on investor protection? Would the impact on investor protection be reduced if we required disclosure of grandfathered events?

(65) Alternatively, should we grandfather only certain disqualifying events? For example, we could grandfather orders arising out of negotiated settlements agreed to before enactment of the Dodd-Frank Act, or before the rules were proposed, adopted or became effective, in light of the possibility that the party would not have agreed to the relevant order if it had known that a collateral consequence of the agreement would be disqualification from all Rule 506 offerings. This would be similar to the approach taken with respect to eligibility for being a "well-known seasoned issuer" when that category was created.[95] Would providing a different treatment for pre-existing negotiated settlements limit the effectiveness of the bad actor disqualification rules?

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[95] For purposes of defining "ineligible issuer" (*i.e.*, an issuer that is not eligible to be a "well known seasoned issuer"), we provided that ineligibility based on settlements would apply only to judicial or administrative decrees or orders entered into after the effective date of the new rules. *See* Release No. 33-8591 (Jul. 19, 2005) [70 FR 44722, 44747]; (available at http://www.sec.gov/rules/final/33-8591.pdf).

(66) Rather than, or in addition to, providing for grandfathering, should we extend waivers previously granted with respect to bad actor disqualification under Regulation A, Rule 505 or Regulation E to cover Rule 506 as well? If we were to consider that approach, are there any categories of such waivers that particularly should or should not be so extended?

**2. Effect on ongoing offerings.** As proposed, our bad actor disqualification provisions would apply to each sale of securities made in reliance on Rule 506 after the rule amendments go into effect. Sales of securities made before the effective date would not be affected by any disqualification that arises as a result of the adoption of the amendments, even if such sales were part of an offering that was intended to continue after the effective date. Only sales made after the effective date of the amendments would be subject to disqualification.

Under the proposal, disqualifying events that occur while an offering is underway would be analyzed in a similar fashion. Sales made before the occurrence of the disqualification would not be affected by it, but sales thereafter would be disqualified unless and until the disqualification is waived or removed.[96]

We believe this approach is consistent with our other rules and provides appropriate incentives to issuers and other covered persons, but are soliciting comment on other possible approaches. If we were to provide that disqualification would be measured only at the time of commencement of an offering, then disqualifying events that arise after commencement would be disregarded. Such an approach could make the rules easier to apply, but would be problematic in light of the statutory language and may compromise investor protection in the context of offerings that continue for extended periods. Conversely, we could provide that all

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96 Disqualifying events that exist at the time the offering is commenced but are only discovered later would be treated the same way if the reasonable care exception applies; otherwise, the sales would not be eligible for reliance on Rule 506.

sales in a continuous offering lose the benefit of the exemption if a disqualification arises during the offering. Such an approach could encourage issuers to avoid involving potentially problematic parties in their offerings, but may be too unpredictable and therefore undermine the benefits of the exemptions.

**Request for Comment**

(67) Is it appropriate for disqualification to apply to sales made after the effective date of the new rules in offerings that are underway at the time the new rules become effective, as proposed?

(68) Is it appropriate for disqualification requirements to apply to each sale of securities, as proposed? Or should we measure disqualifying events only at time of the commencement of an offering? Conversely, should we disqualify all sales in a continuous offering if a disqualification occurs during the offering, including sales that have already been made?

**3. Timing of implementation.** The proposal does not contemplate any phase-in period or delay before issuers would be required to comply with the new disqualification rules. However, given that the new rules may require issuers to take a number of actions before they could confirm that they were not disqualified from relying on Rule 506 (such as, for example, undertaking an inquiry of covered persons, modifying existing due diligence questionnaires, taking steps to remove any existing disqualifications and seeking waivers of disqualification if necessary), it may be appropriate to provide additional time after the rules are adopted but before compliance is required.

**Request for Comment**

(69) Is a relatively shorter implementation period (such as 60 days) appropriate for the new disqualification rules, or should we provide for delayed implementation? If so, how much

time would be appropriate? (90 days? 120 days? Longer?) Please provide support for your views by reference to the actions that issuers would be required to take and an estimate of the time periods involved.

### G. Amendment to Form D

We are proposing a conforming amendment to Form D to reflect that, under our proposal, bad actor disqualification would apply to Rule 506 transactions as well as Rule 505 transactions under Regulation D. The signature block of the current Form D contains a certification that applies only to transactions under Rule 505, confirming that the offering is not disqualified from reliance on Rule 505 for one of the reasons stated in current Rule 505(b)(2)(iii). Under the proposal, this certification would be broadened, so that issuers claiming a Rule 506 exemption would also confirm that the offering is not disqualified from reliance on Rule 506 for one of the reasons stated in Rule 506(c).

## III. POSSIBLE AMENDMENTS TO INCREASE UNIFORMITY

In addition to the matters on which we solicit comment above, we are also soliciting public comment on additional changes to our rules that are not explicitly addressed in Section 926 of the Dodd-Frank Act. We are seeking input on whether any or all of these would enhance our rules by better protecting investors from recidivist bad actors in exempt offerings, avoiding potential sources of confusion and making the rules easier to administer. Although we have not proposed rule text to implement these changes, we are considering them and may adopt them as part of this rulemaking.

### A. Uniform Application of Bad Actor Disqualification to Regulations A, D and E

We are considering and requesting public comment on whether the new bad actor disqualification standards required by the Dodd-Frank Act for Rule 506 offerings should be applied on a more uniform basis. Under our proposal, Rule 506 of Regulation D would be the only exemption subject to the disqualification rules mandated by Section 926 of the Dodd-Frank Act. The other Securities Act exemptions that currently provide for "bad actor" disqualification (Regulation A,[97] Rule 505 of Regulation D,[98] and Regulation E[99]) would continue to follow the disqualification schemes that are currently in effect. Offerings under Rule 504,[100] the remaining Regulation D exemption, would be the only Regulation D exemption not subject to any federal disqualification requirements. We are concerned that there may be confusion, and that compliance costs could be increased, if different disqualification standards apply to these exemptions.[101] We are also concerned that new disqualification standards applicable only to

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97 *See* note 17.

98 17 CFR 230.505. Rule 505 permits offerings of up to $5 million of securities annually, without general solicitation, to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 505 offerings are subject to the same conditions as apply to Rule 506 offerings (*see* note 10 above), except that non-accredited investors are not required to be sophisticated.

99 17 CFR 230.601 through 230.610. Regulation E is an exemption for offerings up to $5 million by small business investment companies ("SBICs") and business development companies ("BDCs"). SBICs are investment funds licensed and regulated by the Small Business Administration that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. *See* Investment Company Act § 2(a)(46), 15 U.S.C. 80a-2(46). A BDC is a closed-end investment company that has elected to be subject to Sections 55 through 65 of the Investment Company Act and that is operated for the purpose of investing in and making significant managerial assistance available to certain types of companies. *See* Investment Company Act § 2(a)(48), 15 U.S.C. 80a-2(48). Regulation E offerings are required to have an offering circular containing specific mandatory information, which is filed with the Commission and subject to review by the staff of the Division of Investment Management.

100 17 CFR 230.504. Rule 504 permits offerings of up to $1 million of securities by issuers that are not (i) reporting companies under the Securities Exchange Act, (ii) investment companies or (iii) development stage companies with no specific business plan or purpose, or whose business plan is to engage in a merger or acquisition with an unidentified entity or entities. Offerings under Rule 504 must generally comply with Regulation D requirements regarding limitations on manner of sale (no general solicitation) and limitations on resale. The manner of sale and resale limitations do not apply, however, to offerings that are subject to state-level registration or that rely on state law exemptions permitting general solicitation so long as sales are made only to accredited investors.

101 Regulation A, Rules 504 and 505 of Regulation D and Regulation E are used much less frequently than Rule 506. For the year ended September 30, 2010, we received 17,292 initial filings for offerings under Regulation D, of which 16,027 claimed a Rule 506 exemption, 254 claimed a Rule 505 exemption, 713 claimed a Rule 504 exemption and 151 claimed both Rule 504 and 506 exemptions. Transactions relying on Regulation A or Regulation E are rare; for the year ended September 30, 2010, seven Regulation A offerings and one Regulation E offering were completed. Note that the staff of the Division of

Rule 506 offerings could negatively affect the market for offerings under our other exemptive rules. We are therefore soliciting comment on whether the proposed new disqualification provisions of Rule 506 should be extended to cover these other exempt offerings.[102]

All bad actor disqualification provisions in our current Securities Act exemptive rules are substantially similar: Rule 505 effectively incorporates by reference Rule 262, with some changes in defined terms,[103] and Rule 602 is substantially similar in its language and effect, although it does not explicitly refer to Rule 262. We are considering whether to preserve this basic uniformity by conforming all existing bad actor disqualification requirements for exempt offerings to the standards proposed to be applied to Rule 506 offerings, and are requesting public comment on that approach.

In the 2007 Proposal, the Commission suggested a uniform approach to disqualification for all offerings under Regulation D.[104] Both in response to the 2007 Proposal[105] and in advance comments on this rulemaking,[106] NASAA voiced support for such a uniform approach. Most comment letters did not support the 2007 Proposal to subject all Regulation D offerings to bad actor disqualification, and particularly objected to applying bad actor disqualification

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Corporation Finance does not routinely review Form D filings to confirm that claimed exemptions are actually available. The figures presented above are based on exemptions claimed in Form Ds that were filed during the relevant period.

102 If we were to adopt a uniform approach, the rules applied to all exempt transactions would give effect to any changes from our proposal that were ultimately adopted (including, for example, the possible inclusion of final orders of the Commission and the CFTC as disqualifying events, on which we have requested comment in Part II.C.3 of this Release).

103 *See* 17 CFR 230.505(b)(2)(iii).

104 *See* note 13.

105 *See* NASAA Comment Letter, note 40.

106 *See* NASAA Advance Comment Letter, note 41.

requirements to Rule 506.[107] Given that the Dodd-Frank Act now requires bad actor disqualification for Rule 506 offerings, and that these constitute a significant majority of transactions under Regulation D, we are considering whether many of the same policy reasons for disqualifying bad actors could be applicable to each of the Regulation D exemptions, as well as to the exemptions under Regulation A and Regulation E, and that uniform disqualification may further investor protection. We are also considering whether imposing uniform disqualification standards across the remainder of Regulation D might promote clarity and simplicity in applying our exemptive rules, and reduce costs imposed by an inconsistent regulatory structure. We also have a concern that adding new disqualification provisions that apply only to offerings under Rule 506 may negatively affect the market for offerings under our other exemptive rules. Bad actors may be encouraged to migrate to offerings under these other exemptions, which would raise investor protection concerns. In addition, investors may perceive a higher risk of fraud in such offerings, which would potentially affect the marketability and issuance costs of all offerings under the exemptions without the new standards, whether or not bad actors are involved.

In order to adopt such a uniform approach, we would have to amend our rules and our proposal in a number of ways, including the following:

- If we applied bad actor disqualification to all Regulation D offerings, we would need to codify the provision as a new paragraph (e) of Rule 502 (the "General Conditions to be Met" for Regulation D offerings) rather than in Rule 506, and would need to delete the current disqualification provisions of Rule 505(b)(2)(iii). The disqualification provisions

107 *See, e.g.*, Comment Letters of the American Bar Association (Oct 12, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-52.pdf); Tenant-in-Common Association (Oct. 17, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-55.pdf); and Davis, Polk & Wardwell (Oct. 9, 2007) (available at http://www.sec.gov/comments/s7-18-07/s71807-39.pdf).

of Rule 262 of Regulation A and Rule 602 of Regulation E would need to be amended to conform to new Rule 502(e).

- We would add underwriters and their directors, officers, general partners and managing members to the categories of covered persons described in the proposal. This would generally harmonize with Rule 262.[108] Underwriters may participate in offerings under Regulation A and Regulation E and in certain transactions under Rule 504 of Regulation D, and so would have to be included if our disqualification rules were to cover such transactions.
- We would need to make a number of changes to harmonize with existing Rule 602 of Regulation E. For example, we would need to add as covered persons, for issuers that are registered investment companies, "private funds" as defined in Section 202(a)(29) of the Investment Advisers Act of 1940 or that elect to be regulated as "business development companies,"[109] their investment advisers and the general partners, managing members, directors and officers of such investment advisers.[110] We would need to add a reference in the paragraph addressing Commission disciplinary orders to orders suspending or revoking registration as an investment company issued under Section 8(e) of the Investment Company Act of 1940, and we would need to add references, in the paragraph

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108 All of these are covered persons under current Rule 262 except for the managing members of underwriters.

109 See note 99.

110 This is one area where the approach under Regulation D, Regulation A and Regulation E would not be completely uniform because of differences in the types of issuers eligible to rely on those regulations. As applied to Regulation D offerings, the rule would cover investment advisers of all entities that describe themselves as "pooled investment funds" on Form D, or that are registered investment company, private fund or BDC issuers, as described in the request for comment in Part II.B above. Regulation A Rule 262 would cover investment advisers of private fund issuers only, because registered investment companies and BDCs are not eligible to rely on Regulation A. Regulation E Rule 602 would cover every issuer's investment advisers; only BDCs and SBICs are eligible to rely on Regulation E (this is also consistent with the approach under current Regulation E Rule 602).

addressing stop orders and orders denying an exemption, to similar proceedings and orders in relation to Regulation E offering circulars.[111]

- A uniform approach would result in a slightly broader universe of disqualifying events, in that events that are disqualifying under only one or two current exemptive rules would apply across the board to Regulation A, Regulation D and Regulation E transactions. Because the existing rules are so similar, the impact of this would be limited to a few matters.[112]
- Under a uniform approach, for the events that are subject to an express look-back period we are considering whether to use the date of the relevant sale, as proposed for Rule 506, rather than to the date of filing of an offering circular, as provided currently under Regulation A and Regulation E, as the measurement date.
- The certification in the signature line of Form D would need to be amended to apply to all Regulation D offerings, not only those under Rule 505 and Rule 506; every issuer claiming a Regulation D exemption would be required to confirm that the offering was not disqualified for any of the reasons stated in the bad actor disqualification rules

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111 To the extent that current bad actor disqualification rules in Rule 602 of Regulation E differ from those in Rule 262 of Regulation A, the uniform approach would result in changes to Rule 602 in addition to those described in Part II of this Release. These would include changes in covered persons (referring to "any beneficial owner of 10% or more of any class of the issuer's equity securities" rather than to any "principal securities holders" and referring to issuer predecessors, affiliated issuers rather than any "affiliate" of the issuer) and the addition of a provision similar to proposed Rule 506(c)(3) with regard to events that predate an affiliate relationship.

112 Specifically, under current rules, an issuer that is disqualified from doing a Regulation E offering because it was the subject of a proceeding to revoke its registered investment company status, or had filed a Regulation E offering circular that was subject to an order suspending the Regulation E exemption, is not disqualified from doing an offering in reliance on Regulation A or D. Similarly, an issuer that is disqualified from doing a Regulation A or Rule 505 offering because it had filed a Regulation A offering circular that was subject to an order suspending the Regulation A exemption, is not disqualified from doing an offering in reliance on Regulation E. Finally, certain convictions and disciplinary orders against covered persons that are municipal securities dealers are currently disqualifying under Regulation A and Rule 505, but not Regulation E. If we were to adopt a uniform approach, any disqualifying event in relation to any covered person would disqualify an issuer from using any of these exemptions.

applicable to Regulation D.

We seek comment on whether incremental changes such as these would unduly restrict reliance upon the exemptions under Regulation A, Rule 505 of Regulation D, and Regulation E, and whether uniform rules would provide clarity and simplicity that may be an overall benefit to investors and other market participants.

We are soliciting comment on a variety of possible approaches to uniformity. For example, we could choose not to pursue a uniform approach, and add new disqualification provisions applicable to Rule 506 transactions only, as proposed. This would leave the existing bad actor provisions applicable to other exemptive rules as they are, and would not subject Rule 504 transactions to bad actor disqualification. We could adopt rules that differentiate between offerings under Regulation A, Rules 505 and 506 of Regulation D and Regulation E, on the one hand (all of which would be subject to the same bad actor disqualification provisions), and Rule 504 offerings on the other hand (which could continue to be conducted without bad actor provisions, or could be subject to some alternative to disqualification, such as mandatory disclosure of the events and circumstances that give rise to disqualification under other exemptive rules). Alternatively, for purposes of Regulation A, Rules 504 and 505 of Regulation D, and Regulation E, we could require disclosure of events that would be disqualifying under Rule 506, without imposing a new disqualification regime.

We are also soliciting comment on whether broadening the impact of the rule changes by uniform application should affect our proposal to not provide for grandfathering of existing disqualifying events. For example, it may be appropriate in that context to differentiate between disqualification provisions that are explicitly addressed in Section 926 of the Dodd-Frank Act and those that are not.

Finally, in considering whether to adopt uniform rules we would also have to consider the relative costs and benefits of such rules and their impact on competition, efficiency and capital formation. We would give particular consideration to their impact on issuers and other market participants (such as placement agents) that are small businesses. Because Regulation A, Rule 505 of Regulation D and Regulation E are relatively little-used, we do not expect the impact in those areas to be significant.

Preliminarily, we believe that uniform application of disqualification standards could have the following effects:

- It may improve investor protection by more effectively excluding bad actors from the private placement and small offering markets.
- It may avoid any confusion that might otherwise arise in applying different disqualification standards to different exemptions and simplify implementation of the new rules.
- It would avoid the creation of actual or perceived loopholes in our rules, which might encourage felons and bad actors disqualified from Rule 506 offerings to migrate to less-regulated kinds of transactions, or create a perception that investors in Rule 506 offerings are more deserving of protection than other investors.
- It may increase investor trust in the integrity of the private placement and small offering markets (which could contribute to a lower cost of capital for issuers).
- On the other hand, it may result in increased costs for issuers, including costs associated with registration if exemptive rules are no longer available, costs associated with terminating relationships with covered persons, or costs associated with executing exempt transactions that are outside the safe harbors and exemptions provided by our

rules. It may also increase compliance costs for issuers, particularly in Rule 504 offerings, which are not currently subject to bad actor disqualification; such issuers could be required to bear additional costs associated with, for example, circulating questionnaires to covered persons, revising questionnaires based on state disqualification rules to cover the new federal disqualification rules, checking publicly available databases and undertaking other factual inquiries.

- Uniform bad actor disqualification rules may increase investor protections and investor trust in the integrity of the private placement and limited offering markets generally, thereby increasing efficiency, potentially decreasing costs for issuers in those markets and providing other benefits to the public. On the other hand, they could impair efficiency if our rules are considered overbroad, or if increased compliance costs are not justified by the direct and indirect benefits of screening a larger universe of disqualified persons out of the market.
- We do not expect that uniform rules would have significant effects on competition, due to the ability of many issuers to avoid disqualification by eliminating bad actors, the availability of other statutory exemptions such as Section 4(2) and Section 4(5) of the Securities Act, and the ability to register offerings for which an exemption is no longer available. For the same reasons, we do not expect that such expanded rules would have a significant impact on costs of capital raising (although, as discussed above, we expect that issuers will incur some incremental costs).
- We expect that the impact on small businesses of uniform rules would be substantially the same as the impact of the amendments we are proposing. See Part IX of this Release for our preliminary analysis of such effects.

**Request for Comment**

(70) Would it be appropriate to apply the proposed disqualification standards uniformly to offerings under Regulation A, Regulation D and Regulation E? Or should we limit the disqualification provisions in the new rule only to those expressly required by the Dodd-Frank Act (*i.e.*, only to Rule 506 transactions), as proposed?

(71) If we were to expand the application of the rules beyond Rule 506 transactions, should we distinguish between conforming the provisions of the exemptive rules that currently have bad actor disqualification requirements (*i.e.*, Regulation A, Rule 505 of Regulation D and Regulation E), on the one hand, and imposing the same requirement on Rule 504 offerings, on the other, given that they are currently not subject to bad actor disqualification at the federal level? Should we adopt disclosure or other rules for Rule 504 offerings as an alternative means of addressing investor protection concerns regarding bad actors in these offerings? What would be the costs and benefits of such a disclosure alternative?

(72) Should we conform the disqualification provisions of Regulation A and Regulation E to the standards proposed in Rule 506(c), or should these provisions continue to reflect current regulatory standards? Since offering documents for both Regulation A and Regulation E offerings are subject to both Commission and state "Blue Sky" review and regulation, would it be appropriate to subject them also to the new federal disqualification provisions required by the Dodd-Frank Act for Rule 506 offerings?

(73) Should we make any additional changes to the proposed covered persons or disqualification events that are specific to Regulation A or Regulation E, reflecting the particular nature of those offerings?

(74) If we were to include investment advisers as covered persons, is it appropriate to limit

coverage to the investment advisers of private fund issuers and BDCs? Or should investment advisers to other issuers also be covered?

(75) If we conformed the bad actor disqualification rules of Regulation A and Regulation E to the new rule we are proposing, should we nevertheless continue to measure look-back periods under Rule 262 of Regulation A and Rule 602 of Regulation E based on the date of filing of the relevant offering circular? Or should we consider a uniform measurement date based on the date of the relevant sale of a security?

(76) If we were to pursue a uniform approach to bad actor disqualification, should this affect our proposal to not provide for grandfathering of disqualifying events that predate adoption of the Dodd-Frank Act or the proposal or adoption of new rules? Would any of the possible changes to each of the current disqualifications have particular effects on those offerings or participants in those offerings that we should take into account? If so, how could we address those effects? Should grandfathering, if any, be limited to disqualification provisions other than those imposed on Rule 506 offerings?

(77) What would the costs and benefits of uniform rules be? Would the benefits justify the costs? How would uniform rules affect competition, efficiency and capital formation?

(78) What would the impact on small businesses be if we imposed uniform rules? Would that be different from the impact of the rule amendments we are proposing, which are limited to Rule 506 offerings? If so, how?

## B. Uniform Look-Back Periods

We are also considering making uniform all of the look-back periods that apply to disqualifying events that have an express look-back period. Rather than using a ten-year period for the final orders of certain state and federal regulators (as required under the Dodd-Frank Act), and for criminal convictions of covered persons other than the issuer, its predecessors and affiliated issuers (as provided under current Rule 262), and a five-year period for all other events subject to an express look-back period, we are considering applying a uniform ten-year look-back to all such events. We request public comment on whether a uniform look-back period would make the rules clearer and easier to apply or would otherwise better promote our regulatory objectives.

(79) Would it be appropriate for us to apply a uniform ten-year period to all disqualifying events that are subject to an express look-back period? Are there any disqualifying events for which the look-back period should be shorter (*e.g.*, five years)? Are there any events for which the look-back period should be longer than ten years? Are there events that should be permanently disqualifying?

(80) If look-back periods were extended, should events that are no longer disqualifying under current rules become disqualifying again? For example, under current rules a court order that is more than five years old is no longer disqualifying under Rule 262. If we extended the look-back period to ten years, a court order issued six years prior, which is no longer disqualifying, would again create a basis for disqualification. Is that appropriate?

(81) What would the costs and benefits be of applying a uniform ten-year look-back period? Would the benefits justify the costs? How would a uniform look-back period affect competition, efficiency and capital formation? Would small businesses be affected differently than they would be under the rules as proposed and, if so, how?

## IV. GENERAL REQUEST FOR COMMENT

We request comment, both specific and general, on each component of the proposals. We request and encourage any interested person to submit comments regarding the proposals that are the subject of this release and other matters that may have an effect on the proposals contained in this release.

Comment is solicited from the point of view of both investors and issuers, as well as of capital formation facilitators, such as investment banks, and other regulatory bodies, such as state securities regulators. Any interested person wishing to submit written comments on any aspect of the proposal is requested to do so.

## V. CHART—COMPARISON OF FELON AND OTHER BAD ACTOR DISQUALIFICATION UNDER CURRENT RULE 262, DODD-FRANK ACT SECTION 926 AND PROPOSED RULE 506(c)

The following chart compares the terms of current Rule 262 (the bad actor disqualification provisions of Regulation A), Section 926 of the Dodd-Frank Act and proposed Rule 506(c). The chart is a convenience summary only and should be read together with (and is qualified in its entirety by) the current rules, any applicable interpretations and the full text of the proposed rules included in this release.

## I. Covered Persons

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(a):<br>Issuer<br>Issuer predecessors<br>Affiliated issuers | 926(1):<br>Regulations that are “substantially similar to the provisions of” Rule 262 | Issuer<br>Issuer predecessors<br>Affiliated issuers |
| 262(b):<br>Directors<br>Officers<br>General partners<br>10% beneficial owners<br>Promoters presently connected with the issuer | | Directors<br>Officers<br>General partners<br>Managing members<br>10% beneficial owners<br>Promoters connected with the issuer at the time of such sale |
| 262(c):<br>Underwriters<br>Partners, directors and officers of underwriters | | Persons compensated for soliciting purchasers[113]<br>General partners, directors, officers and managing members of compensated solicitors |

113 As used in Regulation D Rule 505, the term “underwriter” is defined to mean “a person that has been or will be paid directly or indirectly remuneration for solicitation of purchasers in connection with sales of securities” under the rule. 17 CFR 230.505(b)(2)(iii)(B).

## II. Disqualifying Events

### 1. Criminal convictions

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(a)(3):<br>The issuer, any of its predecessors or any affiliated issuer:<br><br>"has been convicted within 5 years . . . of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission"<br><br>262(b)(1):<br>Any other covered person:<br><br>"has been convicted within 10 years . . . of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of any false filing with the Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser" | 926(2)(B):<br>Rules must disqualify any offering or sale of securities by a person that:<br><br>"has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission" | Any covered person:<br><br>"has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:<br>(A) in connection with the purchase or sale of any security;<br>(B) involving the making of any false filing with the Commission; or<br>(C) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;" |

2. **Injunctions and court orders**

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(a)(4):<br>The issuer, any of its predecessors or any affiliated issuer:<br><br>is subject to any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, entered within 5 years prior to filing, permanently restraining or enjoining, such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the Commission"<br><br>262(b)(2):<br><br>Any other covered person:<br><br>Identical to (a)(4), but adds "or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | Any covered person:<br><br>is subject to any order, judgment, or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:<br>(A) in connection with the purchase or sale of any security;<br>(B) involving the making of any false filing with the Commission; or<br>(C) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities" |

### 3. Final orders of certain regulators

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| No general provision on administrative enforcement actions | Rules must disqualify any offering or sale of securities by a person that:<br><br>"is subject to a final order of a State securities commission (or an agency or officer of a State performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or an agency or officer of a State performing like functions), an appropriate Federal banking agency, or the National Credit Union Administration, that—<br>(i) bars the person from—<br><br>(I) association with an entity regulated by such commission, authority, agency or officer;<br>(II) engaging in the business of securities, insurance or banking; or<br>(III) engaging in savings association or credit union activities; or<br><br>(ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the ten-year period ending on the date of the filing of the offer or sale" | Any covered person:<br><br>"is subject to a final order of a State securities commission (or an agency or officer of a State performing like functions); a State authority that supervises or examines banks, savings associations, or credit unions; a State insurance commission (or an agency or officer of a State performing like functions); an appropriate Federal banking agency; or the National Credit Union Administration, that—<br>(A) at the time of such sale, bars the person from:<br>(1) association with an entity regulated by such commission, authority, agency or officer;<br>(2) engaging in the business of securities, insurance or banking; or<br>(3) engaging in savings association or credit union activities; or<br><br>(B) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale" |

**4. Commission disciplinary orders**

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(b)(3):<br>Any covered person other than the issuer, its predecessors and affiliated issuers:<br><br>"is subject to an order of the Commission entered pursuant to section 15(b), 15B(a) or 15B(c) of the Exchange Act[114], or section 203(e) or (f) of the Investment Advisers Act[115]" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | Any covered person:<br><br>"is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Exchange Act . . . or section 203(e) or (f) of the Investment Advisers Act of 1940 . . . that, at the time of such sale:<br><br>(A) suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;<br>(B) places limitations on the activities, functions or operations of such person; or<br>(C) bars such person from being associated with any entity or from participating in the offering of any penny stock; |

114 The cited sections cover suspension or revocation of registration and certain other sanctions against brokers, dealers and municipal securities dealers.

115 The cited sections cover suspension or revocation of registration and other sanctions against investment advisers.

5. **Suspension or expulsion from SRO membership or association with an SRO member**

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(b)(4):<br>Any covered person other than the issuer, its predecessors and affiliated issuers:<br><br>"is suspended or expelled from membership in, or suspended or barred from association with a member of, a national securities exchange registered under section 6 of the Exchange Act or a national securities association registered under section 15A of the Exchange Act for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | Any covered person:<br><br>"is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade; |

### 6. Stop orders and orders suspending exemptions

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(a)(1):<br><br>The issuer, any of its predecessors or any affiliated issuer:<br><br>"has filed a registration statement which is the subject of any pending proceeding or examination under Section 8 of the Act,[116] or has been the subject of any refusal order or stop order thereunder within 5 years prior to the filing of the offering statement required by § 230.252" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | Any covered person:<br><br>"has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is at the time of such sale the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued" |
| 262(c)(1):<br><br>Any underwriter was or was named as an underwriter of any securities:<br><br>"covered by a registration statement which is the subject of any pending proceeding or examination under Section 8 of the Act, or has been the subject of any refusal order or stop order thereunder within 5 years prior to the filing of the offering statement required by § 230.252" | | |

116 The provision under which stop orders are issued for Securities Act registration statements.

| | | |
|---|---|---|
| <u>262(a)(2):</u><br><br>The issuer, any of its predecessors or any affiliated issuer:<br><br>"is subject to a pending proceeding under § 230.258[117] or any similar rule adopted under section 3(b) of the Securities Act, or to any order entered thereunder within 5 years prior to the filing of such offering statement" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | See above (one paragraph of 506(c) covers the substance of 262(a)(1), (a)(2), (c)(1) and (c)(2)) |
| <u>262(c)(2):</u><br><br>Any underwriter was or was named as an underwriter of any securities:<br><br>"covered by any filing which is subject to any pending proceeding under § 230.258 or any similar rule adopted under section 3(b) of the Securities Act, or to any order entered thereunder within 5 years prior to the filing of such offering statement" | | |

[117] The provision under which the Regulation A exemption would be suspended.

7. **U.S. Postal Service false representation orders**

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| 262(a)(5) and (b)(5):<br>Any covered person:<br><br>"is subject to a United States Postal Service false representation order entered under 39 U.S.C. § 3005 within 5 years prior to filing, or is subject to a temporary restraining order or preliminary injunction entered under 39 U.S.C. § 3007 with respect to conduct alleged to have violated 39 U.S.C. § 3005" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | Any covered person:<br><br>"is subject to a United States Postal Service false representation order entered within five years before such sale, or is at the time of such sale subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations." |

## III. Waivers/Exclusions

| Rule 262 | Dodd-Frank § 926 | Proposed Rule 506(c) |
|---|---|---|
| **Waivers** | | |
| 262 (first unnumbered paragraph):<br><br>Waiver by the Commission<br><br>"upon showing of good cause and without prejudice to any other action by the Commission, [if] the Commission determines that it is not necessary under the circumstances that the exemption provided by this Regulation A be denied" | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | Paragraph (c)(1) of this section shall not apply:<br>(i) upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that the exemption be denied. |
| **Reasonable Care Exception** | | |
| | | (ii) if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed under paragraph (c)(1) of this section.<br>*Instruction to paragraph (c)(2)(ii).* An issuer will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether any disqualifications exist. The nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants. |

| Events Pre-dating Affiliation | | |
|---|---|---|
| 262(a)(5):<br><br>"The entry of an order, judgment or decree against any affiliated entity before the affiliation arose, if the affiliate is not in control of the issuer and if the affiliated entity and the issuer are not under the common control of a third party who was in control of the affiliated entity at the time of such entry does not come within the purview of this paragraph (a) of this section." | No specific provision; regulations must be "substantially similar to the provisions of" Rule 262 | For purposes of paragraph (c)(1) of this section, events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:<br>(i) in control of the issuer or<br>(ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events; |

## VI. PAPERWORK REDUCTION ACT

The proposed amendments do not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.[118] Accordingly, the Paperwork Reduction Act is not applicable and no Paperwork Reduction Act analysis is required.

## VII. COST-BENEFIT ANALYSIS

### A. Background and Summary of Proposals

As discussed above, we are proposing amendments to implement the requirements of Section 926 of the Dodd-Frank Act, relating to the disqualification of "felons and other 'bad actors'" from participation in Rule 506 offerings.

Section 926 of the Dodd-Frank Act requires the Commission to issue rules that disqualify securities offerings involving felons and other bad actors from reliance on the safe harbor provided by Rule 506 of Regulation D. These rules are required to be "substantially similar" to the disqualification rules in Rule 262 (which apply to Regulation A offerings as well as offerings under Rule 505 of Regulation D) and also to cover the matters enumerated in Section 926 (including certain state law orders and bars). The proposal includes a "reasonable care" exception that is not mandated by Section 926. This "reasonable care" exception would prevent an exemption from being lost, despite the existence of a disqualification with respect to a covered person, if the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that the disqualification existed. The proposal also provides the Commission with authority to waive disqualification for good cause shown, similar to its waiver authority under Regulation A.

Section 926 of the Dodd-Frank Act is intended to exclude felons and bad actors from participating in Rule 506 offerings, thereby protecting investors in those offerings.[119] Our rules

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[118] 44 U.S.C. 3501 through 3521.

implementing Section 926 are designed to secure the benefits Congress intended. Our analysis focuses on the costs and benefits of the additional matters that we are proposing that are not specifically mandated by Section 926. Specifically, we have identified certain costs and benefits that may result from the proposal to include a "reasonable care" exception and to provide waiver authority for the Commission. These costs and benefits are analyzed below. We encourage the public to identify, discuss, analyze and supply relevant data regarding these or any additional costs and benefits in comment letters on these proposed rules.

**B. Benefits**

We anticipate that the "reasonable care" exception for issuers would provide a benefit by assuring that issuers would not lose the Rule 506 safe harbor from Securities Act registration because of a disqualification relating to another covered person, so long as they can show that they did not know and in the exercise of reasonable care could not have known of the disqualification. If we did not adopt such an exception, issuers would be at risk of liability for a violation of Section 5 of the Securities Act or of applicable state "blue sky" law if they conducted an offering in reliance on Rule 506 and later learned that a disqualification existed, even if they had exercised reasonable care in determining that there was no disqualification. Without a reasonable care exception, issuers might therefore choose not to undertake offerings in reliance on Rule 506, because the downside (a potential Section 5 or blue sky law violation under circumstances that the issuer cannot reasonably predict or control) may outweigh the intended upside (a relatively speedy and cost-effective means of raising capital). In that scenario, alternative approaches to capital raising may be more costly to the issuer or not available at all. Because Rule 506 is our most frequently relied-upon Securities Act exemptive

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[119] *See* Statement of Senator Dodd, note 93.

rule, the impact of issuers shifting away from it could be significant. We believe that the proposed reasonable care exception would help to preserve the intended benefits of Rule 506, which might otherwise be impaired because of issuer concerns about strict liability for unknown disqualifications.

Similarly, we believe that providing waiver authority for the Commission would provide a benefit to issuers and other covered persons by giving them the opportunity to explain why disqualification should not arise as a consequence of a particular event or the participation of a particular covered person. The Commission's ability to grant waivers could allow more offerings to remain within the Rule 506 safe harbor than would otherwise be the case, which could result in cost savings for issuers relative to the cost of raising capital in a registered offering or in reliance on other exemptions.

**C. Costs**

The inclusion of a reasonable care exception for issuers may impose costs by increasing the likelihood that recidivists will participate in Rule 506 offerings and decreasing the deterrent effect of the bad actor disqualification rules mandated by Section 926 of the Dodd-Frank Act. Participation in Rule 506 offerings by bad actors could result in substantial harm. To the extent that inclusion of a reasonable care exception results in greater involvement of recidivist bad actors in Rule 506 offerings than would otherwise be the case, it would also reduce or eliminate benefits associated with increased investor trust and market integrity.

Issuers may also incur costs associated with conducting and documenting their factual inquiry into possible disqualifications, so they can demonstrate the exercise of reasonable care.

Providing for waiver authority may impose costs by decreasing the deterrent effect of the bad actor disqualification rules, and (to the extent the Commission may grant waivers) by enabling offerings involving bad actors to be conducted under Rule 506 that would otherwise be disqualified. In addition, persons seeking waivers would incur costs in doing so.

Our rules may impose costs on issuers and other market participants in terms of transactions foregone or effected by other means at higher cost. For example, imposing a new disqualification standard only on offerings under Rule 506 may result in higher costs for issuers relying on other exemptive rules, if investors lose trust in offerings under such other rules. We seek comment on any changes that could be made to the proposal, such as modifying the list of covered persons, the nature of disqualifying events, the time periods applicable to disqualifying events or the process for obtaining waivers of disqualification, that could reduce the burden on capital-raising activities without compromising investor protection.

**Request for Comment**

We solicit comments on the costs and benefits of the proposed amendment and on all aspects of this cost-benefit analysis. We request your views on the costs and benefits described above, as well as on any other costs and benefits not already identified that could result from the adoption of our proposal. We encourage the public to identify, discuss, and analyze these or any additional costs and benefits in comment letters. We request that comment letters responding to these requests provide empirical data and other factual support to the extent possible.

## VIII. CONSIDERATION OF BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(b) of the Securities Act[120] requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote

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[120] 15 U.S.C. 77b(b).

efficiency, competition, and capital formation.

Section 926 of the Dodd-Frank Act requires the Commission to adopt provisions to disqualify certain offerings from reliance on the Rule 506 exemption of Regulation D. To the extent our proposed amendments may go beyond the statutory mandate of Section 926 by providing a "reasonable care" exception for issuers and providing waiver authority for the Commission, we believe this would enable issuers to use Rule 506 more effectively and therefore would benefit efficiency and promote capital formation. In particular, the proposed rules are expected to reduce the risk of fraud and other potential securities law violations and increase investor trust in Rule 506 offerings, thereby lowering costs for issuers. We do not anticipate any significant effect on competition.

We request comment on whether the proposal, if adopted, would promote or burden efficiency, competition and capital formation. Finally, we request those who submit comment letters to provide empirical data and other factual support for their views, if possible.

## IX. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

This initial regulatory flexibility analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed amendments to Rule 506 of Regulation D under the Securities Act which would disqualify certain offerings where "felons and other 'bad actors'" are participating or present from the safe harbor from Securities Act registration provided by Rule 506.

### A. Reasons for the Proposed Action

The primary reason for the proposed amendments is to implement the requirements of Section 926 of the Dodd-Frank Act. Section 926 requires the Commission to issue rules under which certain offerings where "felons and other 'bad actors'" are participating or present will be disqualified from reliance on the safe harbor from registration provided by Rule 506 of Regulation D.

**B. Objectives**

Our primary objective is to implement the requirements of Section 926 of the Dodd-Frank Act. In general the rule we are proposing is a straightforward implementation of the statutory requirements. We have included a "reasonable care" exception in the proposed rule, which we believe will make the rule more useful to issuers and should encourage continued use of Rule 506 over exempt transactions outside the Rule 506 safe harbor.

**C. Legal Basis**

The amendment is being proposed under the authority set forth in Sections 4(2), 19, and 28 of the Securities Act and in Section 926 of the Dodd-Frank Act.

**D. Small Entities Subject to the Proposed Rules**

The proposal would affect issuers (including both operating businesses and investment funds that raise capital under Rule 506) and other covered persons, such as financial intermediaries, that are small entities. For purposes of the Regulatory Flexibility Act under our rules, an entity is a "small business" or "small organization" if it has total assets of $5 million or less as of the end of its most recent fiscal year.[121] For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.

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[121] 17 CFR 230.157.

The proposed amendment would apply to small issuers relying on Rule 506 of Regulation D to qualify for a safe harbor from Securities Act registration. All issuers that sell securities in reliance on Regulation D are required to file a Form D with the Commission reporting the transaction. For the fiscal year ended September 30, 2010, 17,292 issuers filed an initial notice on Form D. The vast majority of companies and funds filing notices on Form D are not required to provide information to the Commission that would enable us to establish their size. However, a significant portion of Rule 506 offerings (approximately 40% for the twelve month period ended September 30, 2010), were for amounts of $5,000,000 or less. We believe that many of the issuers in these offerings are small entities, but we currently do not collect information on total assets of companies and net assets of funds to determine if they are small entities for purposes of this analysis.

**E. Reporting, Recordkeeping and Other Compliance Requirements**

The proposed rule would not impose any reporting, recordkeeping or disclosure requirements.[122] We anticipate, however, that issuers would generally exercise reasonable care to ascertain whether a disqualification exists with respect to any covered person, and may document their exercise of reasonable care. The steps required would vary with the circumstances, but we anticipate may include such steps as making appropriate inquiry of covered persons and reviewing information on publicly available databases. We expect that the costs of compliance would generally be lower for small entities than for larger ones because of the relative simplicity of their organizational structures and securities offerings and the generally smaller numbers of individuals and entities involved.

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122 As discussed in Part II.G of this Release, we are proposing to change the form of the signature block of Form D.

### F. Duplicative, Overlapping or Conflicting Federal Rules

We believe there are no federal rules that conflict with or duplicate the proposed amendments.

### G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives of our proposals, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

- the establishment of different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- the clarification, consolidation, or simplification of the rule's compliance and reporting requirements for small entities;
- the use of performance rather than design standards; and
- an exemption from coverage of the proposed amendments, or any part thereof, for small entities.

With respect to the establishment of different compliance requirements or timetables under our proposed amendment for small entities, we do not think this is feasible or appropriate. Moreover, the proposal is designed to exclude "felons and other 'bad actors'" from involvement in Rule 506 securities offerings, which could benefit small issuers by protecting them and their investors from bad actors and increasing investor trust in such offerings. Increased investor trust could reduce the cost of capital and create greater opportunities for small businesses to raise capital. Nevertheless, we request comment on the feasibility and appropriateness for small entities to have different compliance requirements or timetables for compliance with our proposal.

Likewise, with respect to potentially clarifying, consolidating, or simplifying compliance and reporting requirements, the proposed rule does not impose any new reporting requirements. To the extent it may be considered to create a new compliance requirement to exercise reasonable care to ascertain whether a disqualification exists with respect to any offering, the precise steps necessary to meet that requirement will vary according to the circumstances. In general, we believe the requirement will more easily be met by small entities than by larger ones because we believe that their structures and securities offerings are generally less complex and involve fewer participants. We request comment on whether there are ways to clarify, consolidate, or simplify this requirement for small entities.

With respect to using performance rather than design standards, we note that the "reasonable care" exception is a performance standard.

With respect to exempting small entities from coverage of these proposed amendments, we believe such a proposal would be impracticable and contrary to the legislative intent of Section 926. Regulation D was largely designed to provide exemptive relief for small entities. Exempting small entities from bad actor provisions could result in a decrease in investor protection and trust in the private placement and small offerings markets, which would be contrary to the legislative intent of Section 926. We have endeavored to minimize the regulatory burden on all issuers, including small entities, while meeting our regulatory objectives and have included a "reasonable care" exception and waiver authority for the Commission, to give issuers and other covered persons additional flexibility with respect to the application of these proposed amendments. Nevertheless, we request comment on ways in which we could exempt small entities from coverage of any unduly onerous aspects of the proposed amendments.

### H. Request for Comment

We encourage comments with respect to any aspect of this initial regulatory flexibility analysis. In particular, we request comments regarding:

- the number of small entities that may be affected by the proposal or the uniformity and updating alternatives;
- the existence or nature of the potential impact of the proposal and the alternatives on small entities discussed in this analysis; and
- how to quantify the impact of the proposed amendments, or amendments that would implement the alternatives.

We request members of the public to submit comments and ask them to describe the nature of any impact on small entities they identify and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the final regulatory flexibility analysis, if the proposals are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

## X. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"),[123] a rule is "major" if it has resulted, or is likely to result in:

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

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123 Pub. L. No. 104-121, Tit. II, 110 Stat. 857

- significant adverse effects on competition, investment or innovation.

We request comment on whether our proposals would be a "major rule" for purposes of SBREFA. We solicit comment and empirical data on:

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

We request those submitting comments to provide empirical data and other factual support for their views if possible.

## XI. STATUTORY AUTHORITY AND TEXT OF PROPOSED AMENDMENTS

We are proposing the amendments contained in this document under the authority set forth in Sections 4(2), 19 and 28 of the Securities Act, as amended,[124] and Section 926 of the Dodd-Frank Act.[125]

**List of Subjects in 17 CFR Parts 230 and 239**

Reporting and recordkeeping requirements, Securities.

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

## PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The general authority citation for Part 230 is revised to read as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and

124 15 U.S.C. 77c(b), 77c(c), 77d(2), 77r, 77s and 77z-3.

125 Pub. L. No. 111-203, § 926, 124 Stat. 1376 (July 21, 2010)(to be codified at 15 USC 77d note).

80a-37, and Pub. L. No. 111-203, §413(a) and § 926, 124 Stat. 1577 (2010)(15 U.S.C. 77d note), unless otherwise noted.

* * * * *

2. Amend § 230.501 by redesignating paragraphs (g) and (h) as paragraphs (h) and (i), respectively, and adding new paragraph (g) to read as follows:

**§ 230.501 Definitions and terms used in Regulation D.**

* * * * *

(g) *Final order. Final order* shall mean a written directive or declaratory statement issued pursuant to applicable statutory authority and procedures by a federal or state agency described in §506(c)(1)(iii), which constitutes a final disposition or action by that federal or state agency.

* * * * *

3. Amend § 230.506 by redesignating the Note following paragraph (b)(2)(i) as "Note to paragraph (b)(2)(i)" and adding paragraph (c) to read as follows:

**§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.**

* * * * *

(c) *"Bad Actor" disqualification.*

(1) No exemption under this Section 506 shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, officer, general partner or managing member of the issuer; any beneficial owner of 10% or more of any class of the issuer's equity securities; any promoter connected with the issuer in any capacity at the time of such sale; any person that has been or will be paid (directly or indirectly) remuneration for

solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer or managing member of any such solicitor:

(i) Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(ii) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(iii) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; or the National Credit Union Administration that:

(A) At the time of such sale, bars the person from:

(1) Association with an entity regulated by such commission, authority, agency, or officer;

(2) Engaging in the business of securities, insurance or banking; or

(3) Engaging in savings association or credit union activities; or

(B) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale;

(iv) Is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b) or 78o-4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or (f)) that, at the time of such sale:

(A) Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;

(B) Places limitations on the activities, functions or operations of such person; or

(C) Bars such person from being associated with any entity or from participating in the offering of any penny stock;

(v) Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

(vi) Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

(vii) Is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

(2) Paragraph (c)(1) of this section shall not apply:

(i) Upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied; or

(ii) If the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed under paragraph (c)(1) of this section.

*Instruction to paragraph (c)(2)(ii).* An issuer will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether any disqualifications exist. The nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants.

(3) For purposes of paragraph (c)(1) of this section, events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:

(i) In control of the issuer; or

(ii) Under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

**PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933**

4. The general authority citation for Part 239 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78*l*, 78m, 78n, 78o(d), 78u-5, 78w(a), 78*ll*, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

5. Amend Form D (referenced in § 239.500) by revising the third paragraph under the heading "Terms of Submission" in the "Signature and Submission" section following Item 16 to read as follows:

- Certifying that, if the issuer is claiming an exemption under Rule 505 or Rule 506, the issuer is not disqualified from relying on such rule for one of the reasons stated in paragraph (b)(2)(iii) of Rule 505 or paragraph (c)(1) of Rule 506 (as the case may be).

**(Note: The text of Form D does not, and the amendments will not, appear in the Code of Federal Regulations.)**

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: May 25, 2011

Commissioner Casey
Commissioner Paredes
Disapproved

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249

[Release No. 34-64545; File No. S7-33-10]

RIN 3235-AK78

**Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934**

**AGENCY**: Securities and Exchange Commission ("Commission").

**ACTION**: Final rule.

**SUMMARY**: The Commission is adopting rules and forms to implement Section 21F of the Securities Exchange Act of 1934 ("Exchange Act") entitled "Securities Whistleblower Incentives and Protection." The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010 ("Dodd-Frank"), established a whistleblower program that requires the Commission to pay an award, under regulations prescribed by the Commission and subject to certain limitations, to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action. Dodd-Frank also prohibits retaliation by employers against individuals who provide the Commission with information about possible securities violations.

**EFFECTIVE DATE:** [INSERT DATE 60 DAYS FROM PUBLICATION IN THE FEDERAL REGISTER]

**FOR FURTHER INFORMATION CONTACT:** Sean X. McKessy, Securities and Exchange Commission, Division of Enforcement, 100 F Street NE, Washington, DC 20549, Tel. (202) 551-4790, Fax (703) 813-9322.

**SUPPLEMENTARY INFORMATION:** We are adopting new rules 21F-1 through 21F-17, and new Forms TCR and WB-APP, under the Securities Exchange Act of 1934.

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## I. Background and Summary

Section 922 of Dodd-Frank added new Section 21F to the Exchange Act, entitled "Securities Whistleblower Incentives and Protection."[1] Section 21F directs that the Commission pay awards, subject to certain limitations and conditions, to whistleblowers who voluntarily provide the Commission with original information about a violation of the securities laws that leads to the successful enforcement of an action brought by the Commission that results in monetary sanctions exceeding $1,000,000.

On November 3, 2010, we proposed Regulation 21F to implement new Section 21F.[2] The rules contained in proposed Regulation 21F defined certain terms critical to the operation of the whistleblower program, outlined the procedures for applying for

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[1] Pub. L. No. 111-203, § 922(a), 124 Stat 1841 (2010).

[2] Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities and Exchange Act of 1934, Release No. 34-63237 ("Proposing Release").

awards and the Commission's procedures for making decisions on claims, and generally explained the scope of the whistleblower program to the public and to potential whistleblowers.

We received more than 240 comment letters and approximately 1300 form letters on the proposal.[3] Commenters included individuals, whistleblower advocacy groups, public companies, corporate compliance personnel, law firms and individual lawyers, academics, professional associations, nonprofit organizations and audit firms. The comments addressed a wide range of issues. Many commenters provided views on an issue we highlighted in the proposing release – the interplay of the whistleblower program and company internal compliance processes. Commenters also expressed a range of views on other significant issues, including the proposed exclusions from award eligibility for certain categories of individuals or types of information, the availability of awards to culpable whistleblowers, the procedures for submitting information and making a claim for an award, and the application of the statutory anti-retaliation provision.

As discussed in more detail below, we have carefully considered the comments received on the proposed rules in fashioning the final rules we adopt today. We have made a number of revisions and refinements to the proposed rules. Taken together, we believe these changes will better achieve the goals of the statutory whistleblower program and advance effective enforcement of the federal securities laws. The

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[3] The public comments we received are available at http://www.sec.gov/comments/s7-33-10/s73310.shtml. In addition, to facilitate public input on the Dodd-Frank Act, the Commission provided a series of e-mail links, organized by topic, on its website at http://www.sec.gov/spotlight/regreformcomments.shtml.

revisions of each proposed rule are described in more detail throughout this release, but the following are among the most significant:

- **Internal Compliance:** A significant issue discussed in the Proposing Release was the impact of the whistleblower program on companies' internal compliance processes. While we did not propose a requirement that whistleblowers report through internal compliance processes as a prerequisite to eligibility for an award, we requested comment on this topic, and we included in the proposed rules several other elements designed to encourage potential whistleblowers to utilize internal compliance. Commenters were sharply divided on the issues raised by this topic. After considering these different viewpoints, we have determined not to include a requirement that whistleblowers report violations internally, but we have made additional changes to the rules to further incentivize whistleblowers to utilize their companies' internal compliance and reporting systems when appropriate.
  - With respect to the criteria for determining the amount of an award, the final rules expressly provide: first, that a whistleblower's voluntary participation in an entity's internal compliance and reporting systems is a factor that can increase the amount of an award; and, second, that a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.
  - The final rules contain a provision under which a whistleblower can receive an award for reporting original information to an entity's internal compliance and reporting systems, if the entity reports information to the

Commission that leads to a successful Commission action. Under this provision, all the information provided by the entity to the Commission will be attributed to the whistleblower, which means that the whistleblower will get credit -- and potentially a greater award -- for any additional information generated by the entity in its investigation.

- The final rule extends the time for a whistleblower to report to the Commission after first reporting internally and still be treated as if he or she had reported to the Commission at the earlier reporting date. We proposed a "lookback period" of 90 days after the whistleblower's internal report, but in response to comments, we are extending this period to 120 days in the final rules.

- **Procedures for Submitting Information and Claims:** The proposed rules set forth a two-step process for submitting information, which required the submission of two different forms. In response to comments that urged us to streamline the procedures for submitting information, we have adopted a simpler process, combining the two proposed forms into a single Form TCR that would be submitted by a whistleblower under penalty of perjury. With respect to the claims application process, we have made one section of that form optional to make the form less burdensome. We also describe in greater detail below several other features of the process to assist whistleblowers that we expect will become part of the Office of the Whistleblower's standard practice.
- **Aggregation of smaller actions to meet the $1,000,000 threshold**: The proposed rules stated that awards would be available only when the Commission

had successfully brought a single judicial or administrative action in which it obtained monetary sanctions of more than $1,000,000. In response to comments, we have provided in the final rules that, for purposes of making an award, we will aggregate two or more smaller actions that arise from the same nucleus of operative facts. This will make whistleblower awards available in more cases.

- **Exclusions from award eligibility for certain persons and information:** The proposed rules set forth a number of exclusions from eligibility for certain categories of persons and information. In response to comments suggesting that some of these exclusions were overly broad or unclear, we have revised a number of these provisions. Most notably, the final rules provide greater clarity and specificity about the scope of the exclusions applicable to senior officials within an entity who learn information about misconduct in connection with the entity's processes for identifying, reporting, and addressing possible violations of law.

## II. Description of the Rules

### A. Rule 21F-1 – General

Rule 21F-1 provides a general, plain English description of Section 21F of the Exchange Act. It sets forth the purposes of the rules and states that the Commission's Office of the Whistleblower administers the whistleblower program. In addition, the rule states that, unless expressly provided for in the rules, no person is authorized to make any offer or promise, or otherwise to bind the Commission with respect to the payment of an award or the amount thereof.

B. <u>Rule 21F-2 – Definition of a Whistleblower</u>

a. Proposed Rule

As proposed, Rule 21F-2(a) defined a whistleblower as an individual who, alone or jointly with others, provides information to the Commission relating to a potential violation of the securities laws. Under the proposed rule, a company or another entity could not qualify as a whistleblower.

Paragraph (b) of the proposed rule stated that the anti-retaliation protections set forth in Section 21F(h)(1) of the Exchange Act would apply irrespective of whether a whistleblower satisfied all the procedures and conditions to qualify for an award under the Commission's whistleblower program. Similarly, the protections against retaliation applied to any individual who provided information to the Commission about a potential violation of the securities laws.

Paragraph (c) of the proposed rule stated that, to be eligible for an award, a whistleblower must submit original information to the Commission in accordance with all the procedures and conditions described in Proposed Rules 21F-4, 21F-8, and 21F-9.

b. Comments Received

Commenters advanced a number of suggestions to refine the definition of "whistleblower." Many commenters agreed that the definition of "whistleblower" should not turn on whether a violation of the securities laws is ultimately adjudged to have occurred,[4] but expressed differing opinions on our proposal to use the term "potential violation." One commenter agreed that the whistleblower definition should include the

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[4] *See, e.g.*, letters from Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association ("ABA"); Project of Government Oversight ("POGO"); Jones Day; Wells Fargo Advisors, LLC ("Wells Fargo"); and Society of Corporate Governance Professionals.

term "potential violation" because this would allow broad application of the anti-retaliation measures in Section 21F.[5] Several other commenters recommended that the term "potential violation" should be coupled with a requirement that the individual have a "reasonable belief" or "good faith belief" that the information relates to a securities law violation.[6] Some commenters suggested instead of the term "potential violation," we should use the terms "probable violation," "likely violation," or "claimed violation."[7]

On other aspects of the definition of whistleblower, one commenter recommended that we clarify that a "violation of the securities laws" relates only to the federal securities laws and not to violations of state or foreign securities laws.[8] A few commenters recommended that a whistleblower be limited to a person who provided information relating to a "material" violation of the securities laws.[9]

Two commenters disagreed with the proposed rule's limiting whistleblower status to natural persons,[10] suggesting that non-governmental organizations and/or worker representatives, including labor unions, should be permitted to bring claims.[11]

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[5] *See* letter from POGO.

[6] *See, e.g.*, letters from Jones Day; Wells Fargo; and Morgan Lewis. As discussed further below in the text, commenters asserted that a "reasonable belief" or "good faith" standard is necessary to prevent employees from making bad-faith allegations of retaliation.

[7] *See, e.g.*, letters from ABA; Goodwin Procter.

[8] *See* letter from ABA.

[9] *See, e.g.*, letters from ABA; and Society of Corporate Secretaries and Governance Professionals ("Society of Corporate Secretaries").

[10] *See, e.g.*, joint letter from Voices for Corporate Responsibility, Change to Win, National Employment Lawyers Association, Government Accountability Project ("VOICES"); and Mike G. McCluir.

[11] *See* letter from VOICES.

A number of commenters responded to our request for comment on whether we should limit the definition of "whistleblower" to a person who provides information regarding violations of the securities laws "by another person"—some favoring this,[12] others opposing it.[13] Several of the commenters recommended that we limit the whistleblower definition based on an individual's relative culpability for the reported violation. For example, some commenters stated that the definition of "whistleblower" should cover only individuals who report violations by another person, and who did not participate in or facilitate the violations.[14]

Commenters made several suggestions relating specifically to the scope of the anti-retaliation protections. Among other things, commenters recommended that we expressly state in the rules that the anti-retaliation provisions do not apply to an individual if (1) he files a false, fraudulent, or bad faith and meritless submission;[15] (2) he lacks a good faith or reasonable belief of a violation;[16] or (3) the submission does not

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[12] *See* letters from Chris Barnard; Thompson Hine LLP; William A. Jacobson, Angel Prado, and Yaozhi Ye ("Cornell Securities Law Clinic"); Evolution Petroleum Corp.; Securities Industry and Financial Markets Association ("SIFMA"); The Washington Legal Foundation; Morgan Lewis; Continewity LLC; Davis Polk & Wardwell LLP ("Davis Polk"); Oppenheimer Funds.

[13] *See, e.g.*, letters from Grohovsky, Vogel, and Lambert ("Grohovsky Group"); Peter van Schaick.

[14] *See, e.g.*, joint letter from Americans for Limited Government; Ryder Systems, Inc.; Financial Services Institute, Inc.; U.S. Chamber of Commerce; Verizon; and White & Case, LLP ("Chamber of Commerce Group").

[15] *See*, e.g., letters from Connolly & Finkel; National Association of Corporate Directors ("NACD"); Investment Company Institute ("ICI"); Valspar; Auditing Standards Committee of the Auditing Section of the American Accounting Association ("Auditing Standards Committee"); U.S. Chamber of Commerce Center for Capital Markets Competitiveness and the U.S. Chamber of Institute for Legal Reform ("CCMC"); joint letter from General Electric Company, Google, Inc., Honeywell, Inc., JPMorgan Chase & Co., Microsoft Corporation and Northrop Grumman Corporation ("GE Group"); Jones Day; TECO Energy. Two commenters suggested that the Commission should consider "whether it can apply additional sanctions" to any person who uses the whistleblower process in bad faith." *See* joint letter from the Financial Services Roundtable and the American Bankers Association ("Financial Services Roundtable"); letter from TECO Energy.

[16] *See* letters from Chris Barnard; Paul Hastings.

evince a "reasonable likelihood of a violation of securities laws."[17] Another commenter suggested the anti-retaliation provisions should only apply to those who qualify for an award.[18]

Several commenters proposed that the anti-retaliation provisions should categorically exempt a company's adverse action against an employee based on factors other than whistleblower status,[19] such as engaging in culpable conduct,[20] failing to comply with the reporting requirements of a company's internal compliance programs,[21] or violating a professional obligation to hold information in confidence."[22] One commenter explained that, without a categorical exemption, the broad anti-retaliation provisions of the statute could prompt a "wave of litigation" alleging retaliation in such circumstances.[23]

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[17] *See* letter from Goodwin Proctor.

[18] *See* letter from NACD (commenting that not limiting anti-retaliation protection to those who satisfy the conditions for an award "opens the door for employees to submit fake allegations that may cause reputational harm to the company and/or unfairly embarrass corporate employees and leadership").

[19] *See* letters from Thompson Hine; Americans for Limited Government ("ALG"); AT&T; Equal Employment Advisory Council ("EEAC"); Connolly & Finkel; ICI; GE Group; Society of Corporate Secretaries; Association of Corporate Counsel; Financial Services Roundtable; Davis Polk; ABA; joint letter from Allstate Insurance Company, American Institute of Certified Public Accountants, American Insurance Association, Americans for Limited Government, Association of Corporate Counsel, AT&T, Center for Business Ethics, Dover Corporation, FedEx Corporation, Financial Services Institute, Inc., Pharmaceutical Research and Manufacturers of America, Retail Industry Leaders Association, Royal Caribbean Cruises Ltd, Ryder Systems, Inc., UPS, U.S. Chamber of Commerce, U.S. Chamber of Commerce Institute for Legal Reform, Verizon and White & Case, LLP ("Allstate Group").

[20] *See* letters from ALG; Allstate Group; Morgan Lewis; Davis Polk; ABA.

[21] *See* letters from Thompson Hine; *see also* letters from ALG; Allstate Group; Connolly & Finkel; NACD; TECO Energy; Association of Corporate Counsel.

[22] *See* letter from the ABA.

[23] *See* letter from ALG; *see also* letter from Allstate Group.

Commenters made a series of other suggestions related to the scope and enforceability of the anti-retaliation protections, including that we should: (1) clarify our authority to bring enforcement actions based on retaliation;[24] (2) provide that the anti-retaliation remedies may not be waived by any agreement, policy, or condition of employment;[25] and (3) exclude from anti-retaliation protection employees whose submissions are based on information that is either publicly disseminated or which the employee should reasonably know is already known to the company's board of directors or chief compliance officer, a court, the Commission or another governmental entity.[26]

c. Final Rule

In response to the comments, we have made several changes to the definition of whistleblower in Rule 21F-2(a) and the application of the anti-retaliation provisions in Rule 21F-2(b) to more precisely track the scope of Section 21F(h)(1). We are adopting Rule 21F-2(c) as proposed, but have re-designated it as Rule 21F-2(a)(2).

With respect to the definition of whistleblower, we agree with those commenters who suggested that the term "potential violation" may be imprecise, and thus in the final rule have changed this to "possible violation" that "has occurred, is ongoing, or is about to occur." We believe that this modification provides greater clarity concerning when an individual who provides us with information about possible violations, including possible future violations, of the securities laws qualifies as a whistleblower. An individual would

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[24] Letter from Alex Hoover; *see also* letters from Bryan Maloney; National Coordinating Committee for Multiemployer Plans ("NCCMP").

[25] *See* letter from Kaiser Saurborn & Mair.

[26] *See* letter from ABA.

meet the definition of whistleblower if he or she provides information about a "possible violation" that "is about to occur."

Although some commenters recommended that we use the terms "probable violation" or "likely violation," we have decided to use the term "possible violation." In our view, this requires that the information should indicate a facially plausible relationship to some securities law violation—frivolous submissions would not qualify for whistleblower status. We believe that a higher standard requiring a "probable" or "likely" violation is unnecessary, and would make it difficult for the staff to promptly assess whether to accord whistleblower status to a submission.

In the final rule, the definition of whistleblower clarifies that the submission must relate to a violation of the federal securities laws, or a rule or regulation promulgated by the Commission. An individual who submits information that relates only to a state law or foreign law violation would not satisfy the whistleblower definition.

The final rule also clarifies that, to qualify as a whistleblower eligible for the award program and the heightened confidentiality provisions of Section 21F(h)(2) of the Exchange Act, an individual must submit his or her information to the Commission in accordance with the procedures set forth in Rule 21F-9(a).[27] Rule 21F-9(a) establishes procedures for an individual to mail, fax, or electronically submit to us information relating to a possible securities law violation. As proposed, our definition could have been misconstrued to apply to any individuals who provide us with information relating to a securities law violation, including individuals whom we subpoena and law

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[27] The statutory definition of "whistleblower" in Section 21F(a)(6) of the Exchange Act provides that the Commission may "establish by rule or regulation" the "manner" in which an individual provides the Commission information so as to qualify as a whistleblower for purposes of the awards program.

enforcement personnel from other governmental authorities. This result would have been outside the intended scope of Section 21F.

We have not added a requirement that the information relate to a "material" violation of the securities laws. We believe that, rather than use a materiality threshold barrier that might limit the number of submissions to us, it is preferable for individuals to provide us with any information they possess about possible securities violations (irrespective of whether it appears to relate to a material violation) and for us to evaluate whether the information warrants action.[28] To the extent that commenters advanced this suggestion as a way to prevent individuals from abusing the anti-retaliation protections afforded by Section 21F(h) of the Exchange Act, we believe this issue is sufficiently addressed by the revisions to Rule 21F-2(b), discussed further below. To the extent that commenters suggested this approach as a way to reduce frivolous submissions, we believe our use of the term "possible violation" sufficiently addresses this concern.

We have decided not to extend the definition of whistleblower beyond natural persons because we believe that this is consistent with the statutory definition, which provides that a whistleblower must be an "individual." The ordinary meaning of "individual" is "natural person,"[29] and nothing in the statutory text or legislative history suggests a different meaning here. Although one commenter identified a reference to "individuals" in the False Claims Act to argue that the term should be read to extend beyond natural persons, we note that the False Claims Act otherwise repeatedly refers

[28] We do not expect potential whistleblowers to make a fact-dependent materiality assessment.

[29] *See, e.g.*, *Jove Engineering, Inc. v. I.R.S.*, 92 F.3d 1539, 1550-51 (11th Cir. 1996) (quoting BLACK'S LAW DICTIONARY 773 (6th ed. 1996), and WEBSTER'S NEW COLLEGIATE DICTIONARY 581 (8th ed. 1979)).

to whistleblowers as "persons" (which ordinarily extends beyond natural persons),[30] and we believe this explains the different result under that Act.[31]

We have modified proposed Rule 21F-2(b)'s anti-retaliation protections, which are now in Rule 21F-2(b)(1). We are also adding Rule 21F-2(b)(2), which expressly states that the Commission may enforce the anti-retaliation provisions of Section 21F(h)(1) of the Exchange Act and any rules promulgated thereunder.

Rule 21F-2(b)(1) provides that, for purposes of the anti-retaliation protections afforded by Section 21F of the Exchange Act, an individual is a whistleblower if (i) he possesses a reasonable belief that the information he is providing relates to a possible securities law violation (or, where applicable, to a violation of the provisions set forth in 18 U.S.C. 1514A(a)) that has occurred, is ongoing, or is about to occur, and (ii) he reports that information in a manner described in Section 21F(h)(1)(A).

With respect to the first prong of this standard, the employee must possess a "reasonable belief that the information he is providing relates to a possible securities law violation (or, where applicable, to a violation of the provisions set forth in 18 U.S.C.

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[30] *Compare* 31 U.S.C. 3730(e)(4)(B) *with id.* 3730(b)(1) ("A person may bring a civil action ...."), and *id.* 3730(b)(4)(B)(5) ("When a person brings an action ....").

[31] The ABA made several additional recommendations to clarify and/or narrow the definition of whistleblower. *See* letter from ABA. Specifically, the ABA recommended that we: (1) exclude from the definition individuals who provide information that is "clearly stale (*e.g.*, flawed disclosure in a ten-year old proxy statement); (2) require as part of the definition that the individual have a non-speculative "basis in fact or knowledge" to support the potential securities law violation; and (3) exclude from the definition individuals who provide information that is "either publicly disseminated [already] or which the employee should reasonably know is already known to the company's board of directors or chief compliance officer, a court or the Commission or another governmental entity." With respect to clearly stale information, we believe that this is already addressed by the requirement that the information relate to a "possible violation," because we view this term as encompassing a requirement that the violation must be potentially actionable, which would preclude plainly stale violations. Similarly, we believe that the "possible violation" requirement excludes submissions that have *no* "basis in fact or knowledge." Finally, rather than addressing in the threshold definition of whistleblower information that is already publicly known, we have addressed this issue in Rule 21F-4 in the definition of "original information."

1514A(a))[32] that has occurred, is ongoing, or is about to occur." The "reasonable belief" standard requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation, *and* that this belief is one that a similarly situated employee might reasonably possess.[33] We believe that requiring a "reasonable belief" on the part of a whistleblower seeking anti-retaliation protection strikes the appropriate balance between encouraging individuals to provide us with high-quality tips without fear of retaliation, on the one hand, while not encouraging bad faith or frivolous reports, or permitting abuse of the anti-retaliation protections, on the other.[34] This approach is consistent with the approach followed by various courts that have construed the anti-retaliation provisions of other federal statutes, including the False Claims Act,[35] to require that a whistleblower have a reasonable belief that he or she is reporting a

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[32] This parenthetical reflects the fact that the anti-retaliation protection afforded by Section 21F(h)(1)(A)(iii) includes not only reports of securities law violations, but also various other violations of federal law (e.g., 18 U.S.C. §§1341, 1343, 1344, and 1348).

[33] *See, e.g.*, *Livingston v. Wyeth, Inc.*, 520 F.3d 344, 352 (4th Cir. 2008); *Clover v. Total Sys. Servs., Inc.*, 176 F.3d 1346, 1351 (11th Cir.1999).

[34] *See, e.g.*, *Parker v. B&O R. Co.*, 652 F.2d 1012, 1020 (D.C. Cir. 1981) (holding, in Title VII retaliation case, that "[t]he employer is sufficiently protected against malicious accusations and frivolous claims by a requirement that an employee seeking the protection of the opposition clause demonstrate a good faith, reasonable belief that the challenged practice violates Title VII"); *McDonnell v. Cisneros*, 84 F.3d 256, 259 (7th Cir.1996) ("There is nothing wrong with disciplining an employee for filing frivolous complaints"); *Hindsman v. Delta Airlines*, 2010 DOL Ad. Rev. Bd. 58 LEXIS at *10 (ARB Jun. 30, 2010) (interpreting the anti-retaliation provisions of the Wendell H. Ford Aviation Investment and Reform Act, which explicitly excludes frivolous complaints and those brought in bad faith, as requiring a "reasonable belief" by the whistleblower that the violation of the statute has occurred).

[35] *See Fanslow v. Chi. Mfg, Ctr.*, 384 F.3d 469, 480 (7th Cir. 2004) (noting that several circuits had held that the relevant inquiry to determine whether an employee's actions are protected under the False Claims Act is whether "(1) the employee in good faith believes, and (2) a reasonable employee in the same or similar circumstances might believe, that the employer is committing fraud against the government") (citing *Moore v. Cal. Inst. of Tech., Jet Propulsion Lab*, 275 F.3d 838, 845 (9th Cir. 2002); *Wilkins v. St. Louis*, 314 F.3d 927, 933 (8th Cir. 2002), and *McNeil v. Empl. Sec. Dep't*, 2002 Wash. App. LEXIS 1900, at *15-*16 (Wash. Ct. App. Aug. 9, 2002) (same)).

violation of that statute even where the statute does not expressly require such a showing.[36]

The second prong of the Rule 21F-2(b)(1) standard provides that, for purposes of the anti-retaliation protections, an individual must provide the information in a manner described in Section 21F(h)(1)(A). This change to the rule reflects the fact that the statutory anti-retaliation protections apply to three different categories of whistleblowers, and the third category includes individuals who report to persons or governmental authorities *other than the Commission*. Specifically, Section 21F(h)(1)(A)(iii) – which incorporate the anti-retaliation protections specified in Section 806 of the Sarbanes-Oxley Act, 18 U.S.C. 1514A(a)(1)(C) – provides anti-retaliation protections for employees of public companies, subsidiaries whose financial information is included in the consolidated financial statements of public companies, and nationally recognized statistical rating organizations[37] when these employees report to (i) a federal regulatory or law enforcement agency, (ii) any member of Congress or committee of Congress, or (iii) a person with supervisory authority over the employee or such other person working

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[36] *See, e.g., Calhoun v. United States Dep't of Labor* ("*US DOL*"), 576 F.3d 201, 212 (4th Cir. 2009) (anti-retaliation provisions of the Surface Assistance Transportation Act); *Knox v. US DOL*, 232 Fed. App. 255, 258-59 (4th Cir. 2007) (Clean Air Act); *Williams v. US DOL*, 157 Fed. Appx. 575-76 (4th Cir. 2005) (Toxic Substances Control Act, Solid Waste Disposal Act and Clean Air Act); *see also Vinnett v. Mitsubishi Power Systems*, 2010 DOL Ad. Rev. Bd. LEXIS 69 at *12 (ARB Jul. 27, 2010) (Energy Reorganization Act requires "reasonable belief" of violation); *Carter v. Electrical District No. 2 of Pinal County*, 1995 DOL Sec. Labor LEXIS 153 (July 26, 1995) (requiring reasonable belief under anti-retaliation provisions of environmental statutes). Other anti-retaliation provisions, such as the anti-retaliation provisions enacted by Section 806 the Sarbanes-Oxley Act of 2002, expressly contain a "reasonable belief" standard. *See* 18 U.S.C. 1514A(a).

[37] The anti-retaliation protections afforded by Section 806 of the Sarbanes-Oxley Act have also been read to cover employees of agents or contractors of public companies in certain situations. *See Klopfenstein v. PCC Holdings Corp*, 2006 DOL Ad. Rev. Bd. LEXIS 50 (ARB May 31, 2006) (employee of a private subsidiary of a public company was covered under Section 806 where private subsidiary acted at direction of public company in taking adverse action against complainant); *Lawson v. FMR LLC*, 724 F. Supp. 2d 167, 169 (D. Mass. 2010) (employees of private investment advisers to investment companies were covered by Section 806), on appeal, No. 10-2240 (1st Cir.).

for the employer who has authority to investigate, discover, or terminate misconduct. However, the retaliation protections for internal reporting afforded by Section 21F(h)(1)(A) do not broadly apply to employees of entities other than public companies.[38]

In addition, Rule 21F-2(b)(1)(iii) provides that the retaliation protections apply to a whistleblower irrespective of whether the whistleblower is ultimately entitled to an award. This provision of the rule restates a result compelled by the text of Section 21F(h)(1), which on its face provides retaliation protection to whistleblowers irrespective of whether they actually collect an award.[39]

Rule 21F-2(b)(2) states that Section 21F(h)(1) of the Exchange Act, including any rules promulgated thereunder, shall be enforceable in an action or proceeding brought by the Commission. Because the anti-retaliation provisions are codified within the Exchange Act, we agree with commenters that we have enforcement authority for violations of Section 21F(h)(1) by employers who retaliate against employees for making reports in accordance with Section 21F.[40]

With regard to the other significant comments made regarding the anti-retaliation provisions in Rule 21F-2(b), for the reasons set forth below we find that it is either inappropriate or unnecessary to make the modifications that those commenters

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[38] In a few limited situations – reporting by employees of subsidiaries and NRSRO's covered by SOX Section 806, and by employees whose reports were required or protected under SOX or the Exchange Act, see Section 21F(h)(1)(A)(iii) – internal reporting is expressly protected.

[39] Indeed, providing whistleblowers anti-retaliation protection only if they ultimately receive an award could unduly deter whistleblowers from coming forward with information. Under that approach, a whistleblower would not be protected from retaliation if he or she had provided accurate information about the employer's violation, but for some reason no successful Commission action was brought or the whistleblower was not awarded a payment.

[40] Section 21F(h)(1)(B).

recommended. Regarding the comments that we should categorically provide that employees who make whistleblower reports to us may be disciplined for reasons independent of their whistleblowing activities, we think this is unnecessary. By its terms, the statute only prohibits adverse employment actions that are taken "because of" any lawful act by the whistleblower to provide information; adverse employment actions taken for other reasons are not covered. Moreover, there is a well-established legal framework for making this factual determination on a case-by case basis,[41] and we see no indication that Congress intended to depart from this framework here.[42]

With regard to the comment expressing concern that entities might require employees to waive their anti-retaliation rights under Section 21F, we believe that possibility is foreclosed by the Exchange Act. Specifically, because Section 21F is

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[41] This framework involves burden-shifting analysis. *See, e.g, Roadway Express, Inc. v. US DOL*, 495 F.3d 477, 481-82 (7th Cir. 2007); *Scott v. Metropolitan Health Corp.*, 234 Fed Appx. 341, 346 (6th Cir. 2007) (applying burden shifting analysis to retaliation claim under the False Claims Act). *See generally McDonnell Douglas Corp. v. Green,* 411 U.S. 792 (1973). It provides that (1) the employee must first make a *prima facie* case of retaliation (that is, that he or she engaged in protected activity, has suffered an adverse employment action, and that the action was causally connected to the protected activity), (2) the burden then shifts to the employer to articulate a legitimate, non-retaliatory reason for its employment decision, after which (3) the burden shifts to the employee to show that the proffered legitimate reason is in fact a pretext and that the job action was the result of the defendant's retaliatory animus. *E.g., Collazo v. Bristol-Myers Squibb Mfg, Inc.*, 617 F.3d 39, 46 (1st Cir. 2010) (citations and quotations omitted). While anti-retaliation claims brought under the Sarbanes-Oxley Act of 2002 ("SOX") (unlike with Section 21F) are governed by a slightly different framework, under that framework the determination of whether an employee was disciplined for retaliatory or legitimate reasons is likewise a fact-bound inquiry. SOX claims are governed by the procedures applicable to whistleblower claims brought under the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century. *See* 18 U.S.C. 1514A(b)(2). Under that statute, "the employee bears the initial burden of making a prima facie showing of retaliatory discrimination because of a specific act"; once the employee makes that showing, "[t]he burden then shifts to the employer to rebut the employee's prima facie case by demonstrating by clear and convincing evidence that the employer would have taken the same personnel action in the absence of protected activity." *See Day v. Staples, Inc.*, 555 F.3d 42, 53 (1st Cir. 2009).

[42] We note that where Congress intended to categorically exclude from anti-retaliation protections of certain statutes those employees who, without any direction from the employer, deliberatively committed violations of those statutes, it has expressly said so. *See., e.g.*, 33 U.S.C. 1367(d) (excluding such employees from anti-retaliation protections of Federal Water Pollution Control Act); 15 U.S.C. 2622(e) (TOSCA); 42 U.S. 6971(d) (Solid Waste Disposal Act); 42 U.S.C. 7622(g) (Clean Air Act); 42 U.S.C. 9610(d) (CERCLA); 42 U.S.C. 5851(g) (Energy Reorganization Act).

codified in the Exchange Act, it is covered by Section 29(a) of the Exchange Act, which specifically provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or any rule or regulation thereunder . . . shall be void."[43] Thus, under Section 29(a), employers may not require employees to waive or limit their anti-retaliation rights under Section 21F.

C. Rule 21F-3 - Payment of Award

a. Proposed Rule

Paragraphs (a) and (b) of Proposed Rule 21F-3 summarized the statutory requirements for payment of an award based on a covered action or a related action. Paragraph (a) stated that, subject to the eligibility requirements in the Regulation, the Commission will pay an award or awards to one or more whistleblowers who voluntarily provide the Commission with original information that leads to the successful enforcement by the Commission of a federal court or administrative action in which the Commission obtains monetary sanctions totaling more than $1,000,000. Paragraph (b) described the circumstances under which the Commission would also pay an award to the whistleblower based upon monetary sanctions that are collected from a "related action." Payment based on the "related action" would occur if the whistleblower's original information led the Commission to obtain monetary sanctions totaling more than $1,000,000, the related action is based upon the same original information that led to the successful enforcement of the Commission action, and the related action is brought by the Attorney General of the United States, an appropriate regulatory agency, a self-regulatory organization, or a state attorney general in a criminal case.

[43] 15 U.S.C. 78cc(a).

Paragraph (c) of Proposed Rule 21F-3 explained that the Commission must determine whether the original information that the whistleblower gave to the Commission also led to the successful enforcement of a related action using the same criteria used to evaluate awards for Commission actions. To help make this determination, the Commission may seek confirmation of the relevant facts regarding the whistleblower's assistance from the authority that brought the related action. However, the proposed rule stated that the Commission would deny an award to a whistleblower if the Commission determined that the criteria for an award are not satisfied or if the Commission was unable to obtain sufficient and reliable information about the related action.

Paragraph (d) of Proposed Rule 21F-3 provided that the Commission would not make an award in a related action if an award already has been granted to the whistleblower by the Commodity Futures Trading Commission ("CFTC") for that same action pursuant to its whistleblower award program under section 23 of the Commodity Exchange Act.[44] Proposed Rule 21F-3(d) also provided that, if the CFTC has previously denied an award in a related action, the whistleblower will be collaterally estopped from relitigating any issues before the Commission that were necessary to the CFTC's denial.

b. Comments Received

We received a few comments on the proposed rule's treatment of related actions.

One commenter objected to paragraph (c) to the extent that it would preclude a recovery in situations where the Commission is unable to obtain sufficient and reliable information about the related action to make a conclusive determination of the

[44] *See* 7 U.S.C. 26.

whistleblower's contribution to the success of the related action, suggesting instead that the rule include a mechanism for inter-agency coordination to allow the Commission to understand the whistleblower's contribution to the related action.[45] Another commenter challenged paragraph (c) because it would preclude an award for a whistleblower in situations where the Department of Justice or another entity pursues a successful action based on a whistleblower's tip that the Commission forwarded, but the Commission does not bring an enforcement action.[46]

With respect to proposed paragraph (d) and the overlap with CFTC actions, one commenter commended the Commission for clarifying that the Commission will not make an award in a related action if the CFTC has already made an award to the whistleblower on that action,[47] while another acknowledged that there should not be double recoveries, but stated that there should be no automatic rule that would bar rewards because the interaction of the Commission and CFTC programs can be adjudicated on a case-by-case basis.[48]

c. Final Rule

After reviewing the comments, we have decided to adopt Rule 21F-3 substantially as proposed.[49] With respect to related actions, we do not believe that

[45] *See* letter from VOICES.

[46] *See* letter from Stuart D. Meissner, LLC.

[47] *See* letter from Society of Corporate Secretaries.

[48] *See* letter from the National Whistleblowers Center ("NWC").

[49] In the final rule, we have grouped proposed paragraphs (b)-(d) together under the heading "related actions," and renumbered these paragraphs (b)(1)-(b)(3), respectively. We have also changed the term "appropriate regulatory agency" to "appropriate regulatory authority" to more closely comport with the terms of Section 21F and to clarify that our rules regarding payment for awards in connection with related actions govern actions brought by other agencies, not Commission actions. *See* discussion below under Rule 21F-4(g).

inter-agency coordination can always ensure that the Commission will obtain "sufficient and reliable information" about a whistleblower's contribution to the success of a related action, and thus we continue to believe that there is a need for paragraph (b)(2).[50] We have not modified the rule to permit a whistleblower to recover in a related action absent a successful Commission action, because the statute expressly requires a successful Commission action <u>before</u> there can be a "related action" upon which a whistleblower may recover.[51]

With respect to the interrelation with CFTC actions, we are adopting the rule substantially as proposed because it provides claimants with a clear statement of how the Commission will address any issues that arise where a claimant pursues either a double recovery or a "second bite at the apple" by filing an application for an award on a related action after having already pursued an award on the same action under the CFTC's whistleblower awards program.[52] Our Proposing Release had included the

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[50] In cases where the Commission coordinates closely with an entity that ultimately brings a related action, we anticipate that Commission staff will know and will be able to provide information about the whistleblower's contribution to the coordinated efforts. We have added a reference to new Rule 21F-12(a)(5) which provides that neither the Commission nor the Claims Review Staff is permitted to rely upon any information received from the entity that brought the related action if the entity has precluded us from also sharing that information with a claimant. The reference to Rule 21F-12(a)(5) makes clear that if the Commission is unable to receive sufficient and reliable information that is available for the claimant's review, the Commission will deny the claimant's related-action award request.

[51] *See* Section 21F(a)(5) of the Exchange Act, 15 U.S.C. 78u-6(a)(5) (related action must be "based upon the original information ... that led to the successful enforcement of the Commission action").

[52] Several comment letters suggested that a *qui tam* action under the False Claims Act, 31 U.S.C. 3729 *et seq*, could qualify as a "related action." *See, e.g.*, letter from VOICES. This is not correct. A *qui tam* action is not brought by the Attorney General of the United States as is required under the definition of "related action" in Section 21F(a)(5) of the Exchange Act. In a *qui tam* action, the relator "bring[s]" the action "in the name of the Government," *see Vermont Agency of Natural Resources v. United States ex rel. Stevens*, 529 U.S. 765, 769 (2000), and thereafter the Attorney General may "elect to intervene and proceed with the action," 31 U.S.C. 3730(b)(2), 3730(b)(4). Moreover, given that Congress has specifically provided a 15-30% award for successful *qui tam* plaintiffs, *see* 31 U.S.C. 3730(d)(1)-(2), we do not believe Congress intended Section 21F of the Exchange Act to permit additional recovery for the same action above what it specified in the False Claims Act.

qualification that the issue must have been "necessary" to the CFTC's determination, but we believe this requirement would have introduced unwarranted disputes over whether a particular issue was actually necessary. Therefore, we have made a slight modification to provide that the CFTC need only have decided the issue against the award claimant.

D. Rule 21F- 4 – Other Definitions

Although the statute defines several relevant terms, Rule 21F-4 defines other terms that are important to understanding the scope of the whistleblower award program, in order to provide greater clarity and certainty about the operation and scope of the program.

*1. Rule 21F-4(a) – Voluntary submission of information*

*a.* Proposed Rule

Under Section 21F(b)(1) of the Exchange Act,[53] whistleblowers are eligible for awards only when they "voluntarily" provide original information about securities violations to the Commission. Proposed Rule 21F-4(a)(1) defined a submission as made "voluntarily" if a whistleblower provided the Commission with information before receiving any request, inquiry, or demand from the Commission, Congress, any other federal, state or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board about a matter to which the information in the whistleblower's submission was relevant. The proposed rule covered both formal and informal requests. Thus under the proposed rule, a whistleblower's submission would not be considered "voluntary" if the whistleblower was contacted by the Commission or

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[53] 15 U.S.C. 78u-6(b)(1).

one of the other authorities first, whether or not the whistleblower's response was compelled by subpoena or other applicable law.

As our Proposing Release explained, this approach was intended to create a strong incentive for whistleblowers to come forward early with information about possible violations of the federal securities laws, rather than wait to be approached by investigators. For the same reasons, Proposed Rule 21F-4(a)(2) provided that a whistleblower's submission of documents or information would not be deemed "voluntary" if the documents or information were within the scope of a prior request, inquiry, or demand to the whistleblower's employer, unless the employer failed to make production to the requesting authority in a timely manner.

Proposed Rule 21F-4(a)(3) provided that a submission also would not be considered "voluntary" if the whistleblower was under a pre-existing legal or contractual duty to report the securities violations to the Commission or to one of the other designated authorities.

b. Comments Received

Commenters had diverse perspectives on our proposal to require that whistleblowers come forward before they receive either a formal or informal request or demand from the Commission or one of the other designated authorities about any matter relevant to their submission. Some commenters believed that our proposed rule was too restrictive. For example, one commenter urged that all information provided by a whistleblower should be treated as "voluntary" until the whistleblower is testifying under compulsion of a subpoena.[54] Another commenter suggested that persons who

[54] *See* letter from NWC.

are first contacted by an authority should remain eligible for awards if they provide information about transactions or occurrences beyond the specific parameters of the request.[55] A third commenter expressed concern that our proposed rule could have the effect of barring whistleblowers in cases where the whistleblower's information is arguably "relevant" to a general informational request from an authority, even though the authority is not focused on the issue on which the whistleblower might report.[56]

Other commenters took the view that our proposed rule did not go far enough in precluding whistleblower submissions from being treated as "voluntary." A number of commenters urged that our rules also preclude an individual from making a "voluntary" submission after the individual has been contacted for information in the course of a company's internal investigation or other internal review.[57] In response to one specific request for comment, other commenters advocated that we not treat a submission as "voluntary" if the whistleblower was aware of a governmental or internal investigation at the time of the submission, whether or not the whistleblower received a request from the Commission or one of the other authorities.[58]

Our request for comment on whether a whistleblower's submission should be deemed to be "voluntary" if the information was within the scope of a previous request to the whistleblower's employer (Proposed Rule 21F-4(a)(2)) also generated diverse

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[55] *See* letter from Bijan Amini.

[56] *See* letter from Taxpayers Against Fraud ("TAF"). As an example, this commenter pointed out that a request by a municipal bond issuer for completed transaction documents from a Guaranteed Investment Contract ("GIC") provider could be interpreted to preclude a "voluntary" submission of whistleblower allegations that the GIC provider engaged in bid rigging.

[57] *See* letters from CCMC; Jones Day; and GE Group (arguing that a person who is questioned by an employer about a matter should not be permitted subsequently to become a whistleblower unless he or she provided the employer substantially the same information in response to the employer's questioning).

[58] *See* letters from ABA, Wells Fargo, and the Nationals Society of Compliance Professionals ("NSCP").

reactions. Some commenters urged that we eliminate this provision because it could have a sweeping effect in cutting off large numbers of potential whistleblowers, in particular in industry-wide investigations.[59] Other commenters supported the exclusion and suggested that it be expanded in various ways.[60]

Our proposed rule to preclude whistleblowers from acting "voluntarily" if they are under a pre-existing legal or contractual duty to report the violations to the Commission or another authority (Proposed Rule 21F-4(a)(3)) also generated varied comment. Some commenters opposed the exclusion on the grounds that Section 21F(c)(2) of the of the Exchange Act sets forth a specific list of persons whom Congress deemed to be ineligible for awards, some as a result of their pre-existing duties.[61] These commenters urged that the Commission should not expand these exclusions, as doing so would be inconsistent with Congressional intent and would undermine the purposes of Section 21F.[62] One of these commenters asserted, for example, that the proposed rule could result in barring submissions from individual employees if regulators require companies under their jurisdiction to report violations of law, and could also preclude submissions

59 *See* letters from Section on Corporation, Finance and Securities Law of the District of Columbia Bar ("DC Bar"), Daniel J. Hurson, Continewitty LLC.

60 *See* letters from SIFMA (urging elimination of the exception that would permit an employee to make a voluntary submission if the employer did not produce the documents or information in a timely manner), Wells Fargo (same); NCSP (employee should be regarded as having received a request to an employer if there is a reasonable likelihood that the employee would have been contacted by the employer in responding to the request); and the Institute of Internal Auditors (should expand exclusion to other persons within the scope of a request, such as contractors, agents, and service providers).

61 Section 21F(c)(2), 15 U.S.C. 78u-6(c)(2), sets forth four categories of individuals who are ineligible for whistleblower awards. These include employees of the Commission and of certain other authorities, persons who are convicted of a criminal violation in relation to action for which they would otherwise be eligible for an award, auditors in cases where a submission would be contrary to the requirements of Section 10A of the Exchange Act, and persons who fail to submit information in the form required by the Commission's rules.

62 *See* letters from NWC; Stuart D. Meissner, LLC; NCCMP; DC Bar; and Daniel J. Hurson.

from some senior corporate managers who are obligated under federal procurement regulations to report violations of various federal criminal laws, False Claims Act violations and overpayments on government contracts to agency inspectors general and to contracting officers.[63] This same commenter also expressed concern that the Commission should not be in a position of having to decide whether whistleblowers from within state or municipal corporations have pre-existing obligations to report violations.

Other commenters favored the "legal duty" exclusion and recommended that its reach be clarified and extended. In particular, these commenters suggested that the exclusion should be applied to various categories of individuals in the corporate context. Several commenters urged that we not consider submissions to be "voluntary" in circumstances where an employee or an outside service provider has a duty to report misconduct to a company.[64] Another commenter suggested that a company's principal financial officer, principal executive officer, senior management, audit committee, and board of directors should be viewed as having a legal duty to report violations to the government because of the officer certification requirements of Section 302 of the Sarbanes-Oxley Act, and the provisions regarding reporting of illegal acts under Section 10A of the Exchange Act.[65]

Our request for comment concerning whether the "legal duty" limitation on voluntary submissions should apply to all government employees prompted a number of responses. Some commenters appeared to take the view that government employees

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[63] *See* letter from the DC Bar, *citing* 73 Fed. Reg. 67064 (December 2008).

[64] *See* letters from NSCP and from Financial Services Roundtable.

[65] 15 U.S.C. 78j-1; *see* letter from the Cornell Securities Law Clinic.

who are involved in law enforcement or the regulation of business or financial services should be deemed to have a legal duty to report violations.[66] Other commenters indicated that government employees should be viewed as having a duty to report violations that they uncover in the course of their official duties.[67]

Finally, most commenters who responded to our request for comment on whether the list of other authorities in the rule should include foreign authorities stated that foreign authorities should be included.[68] Two commenters argued against this approach. One of these emphasized that the Commission cannot be assured that all foreign authorities will share information they may obtain concerning possible violations of U.S. securities laws, and that it would be difficult for the Commission in many instances to determine whether an individual owed a legal duty under foreign law to report a violation to a foreign authority.[69] Another similarly argued that the fact that a whistleblower received a request from a foreign authority would not compel the whistleblower to provide the information to the Commission.[70]

c. Final Rule

After considering the comments, we have decided to adopt the rule with certain modifications. Although we continue to believe that a requirement that the whistleblower come forward before being contacted by government investigators is both

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66 *See* letters from Patrick Burns, ICI, Auditing Standards Committee, and TRACE International, Inc.

67 *See* letters from the NACD and Grohovsky Group. *See also* letter from the Institute of Internal Auditors ("a general preclusion of government employees would be appropriate.").

68 *See* letters from Auditing Standards Committee; NSCP; Continewity, LLC; Society of Corporate Secretaries; Institute of Internal Auditors.

69 *See* letter from Georg Merkl.

70 *See* letter from VOICES.

good policy and consistent with existing case law from related areas,[71] we agree with the concerns expressed by some commenters that our proposed rule might have the unintended result of deterring high-quality submissions as a threshold matter based on an overly-broad construction of the concept of voluntariness. In response to this concern, we have made several changes to the final rule.

As adopted, paragraph (1) of Rule 21F-4(a) now provides that a submission of information is deemed to have been made "voluntarily" if the whistleblower makes his or her submission before a request, inquiry, or demand that relates to the subject matter of the submission is directed to the whistleblower or anyone representing the whistleblower (such as an attorney) (i) by the Commission; (ii) in connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board ("PCAOB") or any self-regulatory organization;[72] or (iii) in connection with an investigation by Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority.

Thus, rather than apply to all information requests of any kind, as was proposed, our final rule narrows the types of requests that that may preclude a later whistleblower submission from being treated as "voluntary." All requests from the Commission are still covered, as we believe that a whistleblower award should not be available to an individual who makes a submission after first being questioned about a matter (or otherwise requested to provide information) by the Commission staff acting pursuant to

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[71] *Cf. Barth v. Ridgedale Electric, Inc.*, 44 F.3d 699 (8th Cir. 1994); *United States ex rel. Paranich v. Sorgnard*, 396 F.3d 326 (3d Cir. 2005) (rejecting argument that information provided beyond that required by subpoena is voluntary for purposes of False Claims Act); *United States ex rel. Fine v. Chevron, USA, Inc.*, 72 F.3d 740 (9th Cir. 1995), *cert. denied*, 517 U.S.1233 (1996) (rejecting argument that provision of information to the Government is always voluntary unless compelled by subpoena).

[72] The term "self-regulatory organization" is defined in Rule 21F-4(h).

any of our investigative or regulatory authorities. Only an investigative request made by one of the other designated authorities will trigger application of the rule, except that a request made in connection with an examination or inspection, as well as an investigative request, by staff of the PCAOB or a self-regulatory organization will also render a whistleblower's subsequent submission relating to the same subject matter not "voluntary." This provision recognizes the important relationship that frequently exists between examinations and enforcement investigations, as well as our regulatory oversight of the PCAOB and self-regulatory organizations. However, the rule only precludes a whistleblower from making a "voluntary" submission if a previous request, as described, was directed to the whistleblower or to his or her personal representative. For example, an examination request directed to a broker-dealer or an investment adviser would not automatically foreclose whistleblower submissions related to the subject matter of the exam from all employees of the entity. However, if a firm employee were interviewed by examiners, the employee could not later make a "voluntary" submission related to the subject matter of the interview.[73]

We have also narrowed the list of authorities set forth in the rule by limiting state and local authorities to state Attorneys General and state securities regulatory authorities. Accordingly, whistleblowers will have the opportunity to submit information to the Commission "voluntarily" even after they receive requests from other state and local authorities. This change recognizes the fact that the Commission less regularly

[73] As is further discussed below, individuals who wait to make their submission until after a request is directed to their employer will not face an easy path to an award. We expect to scrutinize all of the attendant circumstances carefully in determining whether such submissions "significantly contributed" to a successful enforcement action under Rule 21F-4(c)(2) in view of the previous request to the employer on the same or related subject matter.

receives information through cooperative arrangements with state and local authorities other than state Attorneys General and state securities regulatory authorities.[74]

As adopted, our rule retains the provision (now placed in a newly-designated paragraph (2)) that a whistleblower who receives a request, inquiry, or demand as described in paragraph (1) first will not be able to make a subsequent "voluntary" submission of information that relates to the subject matter of the request, inquiry, or demand, even if a response is not compelled by subpoena or other applicable law.[75] We believe that this approach strikes an appropriate balance between, on the one hand, permitting any submission to be considered "voluntary" as long as it is not compelled, and, on the other hand, precluding a submission from being treated as "voluntary" whenever a whistleblower may have become "aware of" an investigation or other inquiry covered by the rule, regardless of whether the relevant authority contacted the whistleblower for information. A standard based on the receipt of a subpoena would go

[74] We have also determined not to expand the list of authorities in Rule 21F-4(a) to include foreign authorities. Foreign authorities operate under different legal regimes, with different standards. Further, as some commenters pointed out, whether and under what circumstances the Commission may receive information obtained by a foreign authority is more uncertain than is the case of other federal authorities, and state Attorneys General or securities regulators. In addition, we may have limited ability to evaluate the scope of a request from a foreign authority to an individual, and whether it relates to the subject matter of the individual's whistleblower submission. We note, however, that in cases where we request the assistance of a foreign authority to obtain documents or information through a memorandum of understanding, and the foreign authority sends a corresponding request to one of its country's residents, we will treat the request as coming from us for purposes of our rule, with the result that a subsequent whistleblower submission on the same subject matter from the foreign resident will not be treated as "voluntary."

[75] One commenter asked us to clarify that, after a whistleblower makes an initial voluntary submission, if the staff subsequently contacts the whistleblower and requests additional information, any information so provided will be eligible for an award. *See* letter from Stuart D. Meissner, LLC. While we agree that this should ordinarily be the case with respect to routine follow-up communications with most whistleblowers, there may be circumstances where the whistleblower's additional provision of information would not be deemed voluntary. For example, if the whistleblower only provides us with more detailed information pursuant to a cooperation agreement with the Department of Justice, we would not view the whistleblower as having "voluntarily" provided all of the subsequent information. In addition, potential whistleblowers are cautioned that Rule 21F-8(b) requires, as a condition of award eligibility, that a whistleblower provide the staff with all additional information in the whistleblower's possession that is related to the subject matter of the whistleblower's submission in a complete and truthful manner.

too far in permitting individuals to claim whistleblower awards even after being directly asked about conduct by staff of the Commission or other authorities. We do not believe either that Congress intended this result, or that it is suggested by existing law.[76] Conversely, a rule that prohibited a whistleblower from acting "voluntarily" any time the whistleblower became aware of an investigation or other inquiry covered by the rule is overly inclusive because the subject of the inquiry may not be clear to potential whistleblowers with valuable information or these potential whistleblowers may not be known to the Commission. Accordingly, such an interpretation of "voluntary" is likely to have a negative impact on our Enforcement program by reducing the opportunities for us to receive high-quality, valuable information in many circumstances.[77] Such a rule would create the difficult problem of determining whether a whistleblower was actually aware of an investigation or other inquiry before he or she came forward.

For similar reasons, we reject the suggestion of some commenters that a whistleblower should not be permitted to make a "voluntary" submission after being contacted for information in the course of an internal investigation. Elsewhere in our rules, we have attempted to create strong incentives for employees to continue to utilize their employers' internal compliance and other processes for receiving and addressing

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[76] One commenter expressed concern that many employees are required to sign confidentiality agreements that may prevent them from providing information to the Commission without a subpoena. *See* letter from David Sanford. We caution employers that, as adopted, Rule 21F-17(a) provides that no person may take any action to impede a whistleblower from communicating directly with the Commission about a possible securities law violation, including by enforcing or threatening to enforce a confidentiality agreement. Further, Section 21F(h)(1)(A) of the Exchange Act prohibits any form of retaliation by an employer against a whistleblower because of any lawful act done by the whistleblower in providing information to the Commission in accordance with Section 21F. 15 U.S.C. 78u-6(h)(1)(A)(i).

[77] For example, an individual who becomes aware of an investigation and who has valuable information or documents to offer may not, in the ordinary course, be approached by investigators. This is particularly likely to be the case if the individual is not directly or indirectly involved in the conduct under investigation. We do not believe that it would be appropriate to adopt a definition of "voluntary" that might prevent such individuals from coming forward and assisting our staff as whistleblowers.

reports of possible violations of law. If a whistleblower took any steps to undermine the integrity of such systems or processes, we will consider that conduct as a factor that may decrease the amount of any award.[78] However, a principal purpose of Section 21F is to promote effective enforcement of the federal securities laws by providing incentives for persons with knowledge of misconduct to come forward and share their information with the Commission. Although we acknowledge that internal investigations can be an important component of corporate compliance, and although there are existing incentives for companies to self-report violations,[79] providing information to persons conducting an internal investigation, or simply being contacted by them, may not, without more, achieve the statutory purpose of getting high-quality, original information about securities violations directly into the hands of Commission staff.

As noted, paragraph (1) of Rule 21F-4(a) provides that a whistleblower submission will not be deemed "voluntary" if made after we or another of the designated authorities have already contacted the whistleblower (or his or her representative) with an investigative or other covered request, inquiry, or demand that "relates to the subject matter" of the submission. This language is intended to provide clearer guidance than use of the word "relevant" in the proposed rule. The determination of whether an inquiry "relates to the subject matter" of a whistleblower's submission will depend on the nature and scope of the inquiry and on the facts and circumstances of each case. Generally speaking, however, we will consider this test to be met – and therefore the

[78] *See* Rule 21F-6(b)(3).

[79] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001); U.S. Sentencing Guidelines §8C2.5.

whistleblower's submission not to be "voluntary" -- even if the submission provides more information than was specifically requested, if it only describes additional instances of the same or similar conduct, provides additional details, or describes other conduct that is closely related as part of a single scheme. For example, if our staff sends an individual an investigative request relating to a possible fraudulent accounting practice, we would ordinarily not expect to treat as "voluntary" for purposes of Rule 21F-4(a) a subsequent whistleblower submission from the same individual that describes additional instances of the same practice, or a different but related practice as part of an overall earnings manipulation scheme.[80] However, the individual could still make a "voluntary" submission that described other, unrelated violations (*e.g.*, Foreign Corrupt Practices Act violations).[81]

In further consideration of the views expressed that our proposed rule was overly-broad, and could result in precluding too many potential whistleblowers (*e.g.*, in industry-wide investigations), we have decided not to adopt a rule that would treat a request to an employer as directed as well to all employees whose documents or information fall within the scope of the request. (This provision was found in paragraph

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[80] This is a separate analysis from the question of whether information will be deemed to have "led to" a successful Commission enforcement action. As is discussed below, even after we have commenced an investigation or an examination, a whistleblower who voluntarily submits original information may be eligible for an award if the information significantly contributes to the success of our action. *See* Rule 21F-4(c)(2).

[81] We have also added to paragraph (2) a statement that a whistleblower's submission of information to the Commission will be considered "voluntary" if the whistleblower voluntarily provided the same information to one of the other authorities identified in the rule prior to receiving a request, inquiry, or demand from the Commission. This language is intended to respond to comments that, as proposed, our rule could have had the unintended consequence of precluding a submission from being considered as "voluntary" in circumstances where the whistleblower provided the information to another authority, the other authority referred the matter to the Commission, and our staff contacted the whistleblower before he or she had the opportunity to file a whistleblower submission with us. *See* letter from Grohovsky Group.

(2) of Proposed Rule 21F-4(a), and is not part of final Rule 21F-4(a).)[82] As a commenter stated, establishing this requirement as a threshold barrier to submissions could effectively "shut down" our whistleblower program because "any relevant documents or information would almost certainly be covered by an even marginally comprehensive investigative request."[83] Thus, only a request that is directed to the individual involved (or to his or her representative) will preclude that individual from subsequently making a "voluntary" submission of the requested information or closely related information. We note, however, that as part of our determination of whether a submission leads to a successful enforcement action under Rule 21F-4(c), we expect to evaluate whether a previous request to the whistleblower's employer obtained substantially the same information, or would have obtained the information but for any action of the whistleblower in not providing the information to his or her employer. In such circumstances, we ordinarily would not expect to treat the whistleblower's submission has having "significantly contributed" to the success of our action for purposes of Rule 21F-4(c)(2).

We have also decided to revise our proposed requirement that a submission will not be considered "voluntary" if the whistleblower is under a pre-existing legal or contractual duty to report the information to the Commission or to any of the other authorities designated in the rule. As adopted, Rule 21F-4(a)(3) provides that a whistleblower cannot "voluntarily" submit information if the whistleblower is required to report his or her original information to the Commission as a result of a pre-existing

[82] This would include requests that are directed to a specific office or function of an employer where the whistleblower works.

[83] *See* letter from DC Bar.

legal duty,[84] a contractual duty that is owed to the Commission or to one of the other authorities set forth in paragraph (1), or a duty that arises out of a judicial or administrative order.

Unlike in the proposed rule, the final rule provides that a duty to report information only to an authority other than the Commission does not result in exclusion of the whistleblower.[85] We have narrowed the reach of this provision out of concern that, as proposed, it was potentially vague and overbroad. Without a clearer and more specific description of the types of duties owed to these other authorities that might preclude a submission, the proposed rule could have the unintended consequence of discouraging some meritorious whistleblowers. In addition, we have adopted exclusions for specific types of individuals based on the definition of "independent knowledge" under Rule 21F-4(b)(4). Consistent with our approach of applying potential threshold exclusions narrowly, we intend this exclusion to govern only in cases where a whistleblower has an individual duty to report to the Commission, and not in cases where the duty belongs to the whistleblower's employer.

Although this determination of "voluntariness" turns on whether the whistleblower is under a duty to report information to the Commission, the duty to report to the Commission can arise from a contract with either the Commission or with one of the

[84] Although in certain circumstances auditors have pre-existing legal duties to report information about securities law violations to the Commission, for purposes of these rules, an auditor's eligibility for a whistleblower award will not be addressed under this rule, but will be addressed under Rules 21F-4(b)(4)(iii) and (v) and Rule 8(c)(4).

[85] As noted above, some commenters objected to the proposed rule on the grounds that Congress expressly only declared certain categories of whistleblowers to be ineligible as a result of their pre-existing legal duties. However, Congress did not define the term "voluntarily" as used in Section 21F, instead leaving it to the Commission to interpret this term and others in a manner that furthers the statutory purposes. *See* Section 21F(j), 15 U.S.C. 78u-6(j).

other authorities identified in the rule. Thus, the rule would not consider as "voluntary" disclosures made by an individual who has entered into a cooperation or similar agreement with another authority, such as the Department of Justice, which requires the individual to cooperate with or provide information to the Commission, or more generally to government agencies. Further, the requirement that the contractual duty be owed to the Commission or to one of the other authorities means that whistleblowers will not be precluded from award eligibility if they are subject to a contractual duty to report information to the Commission because of an agreement with a third party. In other words, submissions from such whistleblowers will be treated as "voluntary," assuming that the other requirements of this rule are satisfied. This clarification responds to the concerns of some commenters that employers should not be able to preclude their employees from whistleblower eligibility by generally requiring all employees to enter into agreements that they will report evidence of securities violations directly to the Commission.[86]

The rule also provides that a whistleblower submission will not be treated as "voluntary" if the whistleblower had a duty arising out of a judicial or administrative order to report the information to the Commission. This language covers persons such as independent monitors or consultants who may be appointed or retained as a result of Commission or other proceedings with a requirement that they report their findings, conclusions, or other information to the Commission.

Finally, this rule will not apply to an employee or a third party who has a duty of some kind to report misconduct to a company, as we believe that a wholesale exclusion

[86] *See* letters from Stuart D. Meissner and Georg Merkl.

of whistleblower submissions in such cases would not effectuate the purposes of Section 21F.

*2. Rule 21F-4(b) – Original Information*

As proposed, Rule 21F-4(b)(1) tracked the definition of "original information" found in Section 21F(a)(3) of the Exchange Act, with the added requirement that the information must be provided to the Commission for the first time after the date of enactment of Dodd-Frank. We are adopting the rule as proposed.

a. Proposed Rule

Our proposed rule defined "original information" to mean information that is: (i) derived from the independent knowledge or independent analysis of the whistleblower; (ii) not already known to the Commission from any other source, unless the whistleblower is the original source of the information; (iii) not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information;[87] and (iv) provided to the Commission for the first time after July 21, 2010 (the date of the enactment of Dodd-Frank). The first three requirements recited the definition of "original information" found in Section 21F(a)(3) of the Exchange

[87] In our Proposing Release we stated that we will interpret the term "judicial or administrative hearing" to include hearings in arbitration proceedings. *See* Proposing Release note 19. One commenter expressed concern that this interpretation would prevent a plaintiff in arbitration from making a whistleblower submission on the basis of his allegations and the evidence adduced at the hearing. *See* letter from Stuart D. Meissner, LLC. However, in that instance, the plaintiff would qualify as the source of the allegations, and nothing in the definition of "original information" would preclude the plaintiff from using evidence adduced at the hearing to support his or her submission to the Commission. Rather, our inclusion of arbitration hearings within the scope of the rule would preclude others who are involved with the arbitration – such as the reporter, or an arbitrator – from using the plaintiff's allegations to make a whistleblower submission for their own benefit.

Act. The fourth requirement made clear that awards would be considered only for original information submitted after the enactment of Section 21F.

Some of the elements of this definition – specifically, "independent knowledge," independent analysis," and "original source" – are defined in other proposed rules, and are separately discussed below.

b. Comments Received

Some commenters urged that our definition of "original information" be broadened in various ways. One commenter suggested that "original information" should include information that was provided to the Commission before the enactment of Dodd-Frank if the information leads to an enforcement action after the date of enactment.[88] Another commenter offered that "original information" should include information an employee reports to his or her company and that is later reported to the Commission by the company.[89] Similarly, another commenter expressed concern that, because "original information" must be information that is "not already known" to the Commission, the definition appeared to exclude subsequent whistleblowers who provide additional helpful information.[90] This commenter urged that we not automatically exclude subsequent whistleblowers, but instead make an appropriate award allocation among the individuals involved.

Other commenters believed that our definition of "original information" should be narrowed to exclude certain information from consideration for an award. Two

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[88] *See* letter from Bijan Amin; *see also* pre-proposal letter from James Hill.

[89] *See* letter from Hunton & Williams LLP.

[90] *See* letter from DC Bar.

commenters suggested that our rule exclude information beyond the statute of limitations period for actions to recover penalties.[91] One of these commenters also urged that "original information" should not include information about a violation that has already been addressed by the entity that is alleged to have violated the securities laws.[92]

Another commenter expressed concern that, as proposed, "original information" would not clearly exclude information a whistleblower receives as a result of an investigation by a securities exchange or other self-regulatory organization, a foreign regulator, or information received in connection with internal investigations or civil or criminal proceedings.[93] This commenter urged that the rule be modified to exclude information derived from any investigative or enforcement activity or proceeding, and not merely the types of proceedings set forth in the statute (*i.e.*, "an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation").

c. Final Rule

After considering the comments, we are adopting Rule 21F-4(b)(1) as proposed. Congress enacted Section 21F in order to provide new incentives for individuals with knowledge of securities violations to report those violations to the Commission. We believe that applying Section 21F prospectively – for new information provided to the Commission after the statute's enactment and not to information previously submitted –

[91] *See* letters from ICI and SIFMA.

[92] *See* letter from ICI.

[93] *See* letter from ABA.

is most consistent with Congressional intent and with the language of the statute.[94] Similarly, we do not believe that it would be consistent with Congressional intent for our rules to categorically exclude through the definition of "original information" tips about violations that may arguably be beyond an applicable statute of limitations or that a company may have addressed through remedial action. Rather, considerations such as these are better addressed through our exercise of discretion in determining whether to open an investigation, whether to bring an enforcement action, and the nature and scope of any action filed and relief granted.

In other respects, we believe that our final rules substantially address the issues raised by the commenters. For example, under Rules 21F-4(b)(5) and (6) an individual can be considered the original source of information provided to the Commission by another source (including the individual's employer), or of information that "materially adds" to information already in our possession. Further, Rule 21F-4(c), as adopted, provides that a whistleblower may be eligible for an award based upon information that the whistleblower reports through a company's internal legal and compliance procedures if the company subsequently provides the information to the Commission. In addition, Rule 21F-4(c) provides that, even after an investigation has commenced, a whistleblower can be eligible for award consideration if he or she provides original information that significantly contributes to the success of the Commission's action. Thus, our rules will permit awards to subsequent whistleblowers in appropriate circumstances.

[94] Section 924(b) of Dodd-Frank provides that "Information provided to the Commission in writing by a whistleblower shall not lose the status of original information ..., if the information is provided by the whistleblower after the effective date of this subtitle."

Similarly, we believe that several provisions in our rules will ordinarily operate to exclude whistleblowers whose only source of original information is an existing investigation or proceeding. Information that is exclusively derived from a governmental investigation is expressly excluded from the definition of "original information" under Section 21F(a)(3) of the Exchange Act and our Rule 21F-4(b)(1)(iii). A whistleblower who learns about possible violations only through a company's internal investigation will ordinarily be excluded from claiming "independent knowledge" by operation of either the exclusions from "independent knowledge" set forth in Rules 21F-4(b)(4)(i), (ii), and (iii) (relating to attorneys, auditors, and other persons who may be involved in the conduct of internal investigations), or by Rule 21F-4(b)(4)(vi) (excluding information learned from such individuals). To the extent that information about an investigation or proceeding is publicly available, it is excluded from consideration as "independent knowledge" under Rule 21F-4(b)(2).[95]

*3. Rule 21F-4(b)(2) – Independent knowledge*

Proposed Rule 21F-4(b)(2) defined "independent knowledge," one of the constituent elements of "original information," as factual information not derived from publicly available sources. We are adopting the rule as proposed.

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[95] Further, Form TCR, to be used for whistleblower submissions, requires the whistleblower to state, under penalty of perjury, how he or she obtained the information that is the subject of the submission. A truthful answer that the whistleblower obtained the information from an investigation by a securities exchange or a self-regulatory organization – if the staff were not already aware of the investigation – would likely lead the staff to contact the other authority directly for additional information. In these circumstances, where information is obtained through the normal cooperative arrangements between the Commission and other regulators, the whistleblower's submission would not be deemed to have caused the opening of an investigation, or to have significantly contributed to the success of any action, such as to make the whistleblower eligible for an award under Rule 21F-4(c).

a. Proposed Rule

Under our proposed rule, "independent knowledge" was defined to mean factual information in the whistleblower's possession that is not derived from publicly available sources. As we explained in our Proposing Release, publicly available sources may include both sources that are widely disseminated (such as corporate press releases and filings, media reports, and information on the internet), and sources that, though not widely disseminated, are generally available to the public (such as court filings and documents obtained through Freedom of Information Act requests). Further, as proposed, the definition of "independent knowledge" did not require that a whistleblower have direct, first-hand knowledge of possible violations. Instead, knowledge could be obtained from any of the whistleblower's experiences, observations, or communications (subject to the exclusion for knowledge obtained from public sources, and subject further to the exclusions set forth in Rule 21F-4(b)(4)).

b. Comments Received

Several commenters supported our proposed definition of "independent knowledge."[96] Others were critical of the definition for different reasons. Some commenters criticized our exclusion of information derived from publicly available sources, and urged that awards be available for tips that are based upon various kinds of public information.[97] One of these commenters argued that, because Section 21F does not contain an express exclusion for all information derived from publicly available

[96] *See* Letters from Institute of Internal Auditors, Patrick Burns, Auditing Standards Committee, Georg Merkl.

[97] *See* Letters from the VOICES, Wanda Bond, Michael Lawrence, and TAF; *see also* pre-proposal letter from Robin McLeish.

sources, the only public information that can be excluded from award consideration is information that is derived from the sources that are set forth in Section 21F(a)(3)(C) – *i.e.*, a judicial or administrative hearing, a government report, hearing, audit, or investigation, or the news media.[98] This commenter stated that this interpretation would be consistent with the application of the "public disclosure bar" of the False Claims Act, 31 U.S.C. §3730(e)(4)). Similarly, this commenter argued that our proposal to exclude publicly-available information from the definition of "independent knowledge" was unsupportable because the statute only excludes claims based upon information that is "already known to the Commission."[99]

We requested comment on whether it is appropriate to consider knowledge that is not direct, first-hand knowledge as "independent knowledge" In response, one commenter urged that we limit "independent knowledge" to first-hand knowledge of the whistleblower.[100] This commenter expressed concerned about the reliability of second-hand information, and the potential that our rule could harm companies by creating an incentive for whistleblowers to report unsubstantiated rumors and other unreliable information. This commenter also suggested that the absence of a first-hand knowledge requirement would encourage circumvention of the statute by permitting persons who are ineligible for awards to give information to third persons in order to enable them to become whistleblowers.

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[98] *See* letter from TAF; *see also* letter from VOICES.

[99] Section 21F(a)(3)(B), 15 U.S.C. 78u-6(a)(3)(B). *See* letter from TAF.

[100] *See* letter from ABA.

c. Final Rule

After considering the comments, we are adopting Rule 21F-4(b)(2) as proposed. Accordingly, "independent knowledge" means any factual information in the whistleblower's possession that is not derived from publicly available sources. Congress primarily intended our whistleblower program "...to motivate those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated the securities laws...."[101] It is consistent with this purpose to require that "independent knowledge" be derived from a whistleblower's own experiences, observations, or communications, and not from information that is available to the general public.[102]

The objection that our rule should permit submissions based upon public information as long as the information is not derived from a judicial or administrative hearing, a governmental report, hearing, audit, or investigation, or from the news media is not supported by the plain language of Section 21F. The definition of "original information" found in Section 21F(a)(3) requires both that the information be derived from the whistleblower's independent knowledge or analysis (Section 21F(a)(3)(A)), and that it also not be exclusively derived from an allegation in one of these fora (Section 21F(a)(3)(C)). If "independent knowledge" were interpreted to mean merely that the information could not be derived from one of the sources specified in Section

[101] S. Rep. No. 111-176 at 110 (2010).

[102] However, publicly available information can be included as part of a submission of "independent analysis" under Rule 21F-4(b)(3). *See* discussion below.

21F(a)(3)(C), then the separate requirement that the whistleblower also have "independent knowledge" would have no meaning.[103]

The same analysis applies to the suggestion that "independent knowledge" cannot exclude publicly-available information and can only exclude information that is "not known to the Commission" from any other source. The requirement of "independent knowledge" is set forth in Section 21F(a)(3)(A) of the Exchange Act, and is distinct from the requirement in Section 21F(a)(3)(B) that information be not already known to the Commission. In other words, both tests must be met separately as part of the determination of whether information qualifies as "original information."

While we thus exclude information derived from publicly available sources from the definition of "independent knowledge," we do not believe that "independent knowledge" should be further limited to direct, first-hand knowledge. Such an approach could prevent the Commission from receiving valuable information about possible violations from whistleblowers who are not themselves involved in the conduct at issue, but who learn about it through their observations, relationships, or personal diligence.[104]

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[103] The "public disclosure bar" of the False Claims Act operates differently. There, "independent knowledge" is not a separate requirement, but instead is one element of an exception to the rule that otherwise requires a court to dismiss an action if substantially the same allegations or transactions were publicly disclosed in certain specified fora, such as a federal hearing in which the Government is a party, a federal government report or investigation, or the news media. 31 U.S.C. 3730 (e)(4).

[104] Further, as discussed in our Proposing Release, Congress recently amended the "public disclosure bar" provisions of the False Claims Act, replacing the requirement that a qui tam plaintiff have "direct and independent knowledge" of information with one requiring only "knowledge that is independent and materially adds to the publicly-disclosed allegations or transactions..." 31 U.S.C. 3130(e)(4), Pub. L. No. 111-148 §10104(h)(2), 124 Stat. 901 (Mar. 23, 2010). Courts generally defined "direct knowledge" to mean first-hand knowledge from the relator's own work and experience, with no intervening agency. *E.g., United States ex rel. Fried v. West Independent School District*, 527 F.3d 439 (5th Cir. 2008); *United States ex rel. Paranich v. Sorgnard*, 396 F.3d 326 (3d Cir. 2005). Although, as noted in our Proposing Release, we do not believe that False Claims Act interpretations and precedent are necessarily authoritative for purposes of Section 21F, we note that Congress recently amended the False Claims Act to eliminate the requirement of first-hand knowledge.

Our final rules provide that, in order to be considered eligible for an award, a whistleblower must provide information that is sufficiently specific, credible, and timely that it causes the staff to open an investigation, or significantly contributes to the success of an enforcement action.[105] We believe that commenters' concerns about whistleblowers providing wholly speculative or unsubstantiated information is most effectively addressed in connection with these determinations rather than by requiring first-hand knowledge as a threshold limitation for whistleblower submissions.[106]

*4. Rule 21F-4(b)(3) – Definition of independent analysis*

a. Proposed Rule

Under Proposed Rule 21F-4(b)(3), "analysis" was defined to mean the whistleblower's own examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available to the public. Analysis was defined as "independent" if it was the whistleblower's own analysis, whether done alone or in combination with others. As was explained in our Proposing Release, this definition was intended to recognize that there are circumstances where individuals can review publicly available information, and, through their additional evaluation and analysis, provide vital assistance to the Commission staff in understanding complex schemes and identifying securities violations.

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[105] *See* Rule 21F-4(c), discussed below.

[106] We have addressed commenters' concern about possible collusion through our revised Rule 21F-8(c)(6).

b. Comments Received

Although we received few responses to our request for comment on suggested alternative definitions of "independent analysis,"[107] most commenters who addressed the proposed rule appeared to agree with the rule's fundamental premise that "independent analysis" anticipates that the whistleblower will apply his or her own evaluation and insight to information that may be derived from publicly available sources.[108] Two commenters suggested we clarify that "independent analysis" can be based on public sources, including the sources described in Section 21F(a)(3)(C) and Proposed Rule 21F-4(b)(1)(iii).[109] One commenter criticized our proposed definition of "independent analysis" on the ground that the requirement that analysis reveal information that is "not generally known or available" would preclude an award to a whistleblower who caused us to focus on publicly available information of which we were not otherwise aware.[110] Another commenter urged that "independent analysis" be restricted to analysis of the whistleblower's own "independent knowledge," defined by the commenter to be limited to first-hand knowledge, along with other purely objective facts such as share price or trading volume.[111]

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[107] *See* letters from Wanda Bond, Auditing Standards Committee, and Kurt S. Schulzke.

[108] *See* letters from Wanda Bond, Auditing Standards Committee, Kurt S. Schulzke, POGO (referencing the importance of whistleblowers "who often perform original analysis based on publicly available sources").

[109] *See* letters from POGO and VOICES.

[110] *See* letter from TAF.

[111] *See* letter from ABA.

c. Final Rule

After considering the comments, we are adopting Rule 21F-4(b)(3) as proposed, with a slight modification to clarify that "independent analysis" can be based upon the whistleblower's evaluation of publicly available sources.[112] Thus, as adopted, Rule 21F-4(b)(3) defines "analysis" to mean the whistleblower's own examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.

We believe that "independent analysis" requires that the whistleblower do more than merely point the staff to disparate publicly available information that the whistleblower has assembled, whether or not the staff was previously "aware of" the information. "Independent analysis" requires that the whistleblower bring to the public information some additional evaluation, assessment, or insight.

As with other elements of the definition of "original information," we anticipate that whether "independent analysis" provided to the Commission may be eligible for award consideration will primarily depend (assuming all other requirements are met) on an evaluation of whether the analysis is of such high quality that it either causes the staff to open an investigation, or significantly contributes to a successful enforcement action, as set forth in Rule 21F-4(c). This analysis is discussed further below.

For reasons similar to those discussed above with respect to the definition of "independent knowledge," we also do not believe it would be consistent with the purposes of Section 21F to restrict "independent analysis" to analysis based upon facts of which the whistleblower has direct, first-hand knowledge. Such an interpretation

[112] This would include public information that may be derived from the sources identified in Section 21F(a)(3)(C) and Rule 21F-4(b)(1)(iii); *i.e.*, a judicial or administrative hearing, a government report, hearing, audit, or investigation, or the news media.

would preclude award consideration even for highly-probative, expert analysis of data that may suggest an important new avenue of inquiry, or otherwise materially advance an existing investigation. We do not believe that Congress intended this result.

### 5. *Rules 21F-4(b)(4)(i) through (vi) – Exclusions from Independent Knowledge and Independent Analysis*

Proposed Rules 21F-4(b)(4)(i) through (vii) described circumstances under which we would not consider a whistleblower's submission to be derived from independent knowledge or independent analysis. We are adopting a number of these exclusions, but with significant revisions in response to comments that we received.[113] These comments and the resulting modifications to the rules are discussed below with respect to the specific exclusions. In this section, we briefly address the exclusions as a whole.

#### a. Proposed Rules

As proposed, Rule 21F-4(b)(4) provided that the Commission would not credit a whistleblower with "independent knowledge" or "independent analysis" where the whistleblower obtained the knowledge, or the information upon which the whistleblower's analysis was based, under certain circumstances. These included information that was: (1) subject to attorney-client privilege or otherwise obtained in connection with the legal representation of a person or entity (proposed Rules 21F-4(b)(4)(i) and (ii)); (2) obtained through the performance of an engagement required under the securities laws by an independent public accountant, if the information related to a violation by the engagement client, or the client's officers, directors, or employees (proposed Rule 21F-4(b)(4)(iii)); (3) communicated to a person with legal, compliance,

[113] We have also added the phrase "in any of the following circumstances" in the opening clause of Rule 21F-4(b)(4) in order to make clear that information is excluded from being considered as "independent knowledge" or "independent analysis" if any one of the exclusions apply.

audit, supervisory, or governance responsibilities for an entity with the reasonable expectation that he or she would cause the entity to respond appropriately (proposed Rule 21F-4(b)(4)(iv)); (4) otherwise obtained through an entity's legal, compliance, audit, or similar functions or processes for identifying, reporting, and addressing potential non-compliance with law (proposed Rule 21F-4(b)(4)(v)); (5) obtained in violation of federal or state criminal law (proposed Rule 21F-4(b)(4)(vi)); and (6) obtained from any of the persons excluded by Rule 21F-4(b)(4). Certain of these exclusions were subject to exceptions that are discussed below in connection with the specific rules.

b. Comments Received

Some commenters generally criticized our approach of defining exclusions from "independent knowledge" and "independent analysis." These commenters argued that Section 21F does not permit any exclusions from award eligibility other than those expressly provided for in Section 21F(c)(2). They also expressed concern that the proposed exclusions were vague and uncertain, and therefore would discourage potential whistleblowers from taking the personal and professional risks associated with coming forward. These commenters also believed that the exclusions would operate to disqualify broad categories of individuals who are most likely to have information about misconduct.[114]

In our Proposing Release, we requested comment on whether we should extend the exclusions from "independent knowledge" and "independent analysis" to other professionals (in addition to attorneys and independent public accountants) who may

[114] *See* letters from TAF and NWC; *see also* letter from Stuart D. Meissner, LLC.

obtain information about possible securities violations in the course of their work for clients. A number of commenters urged that we do so. These commenters emphasized that boards and companies frequently retain outside consultants to advise them on matters such as compensation, business strategies, risk, and the effectiveness of their ethics and compliance programs. These commenters expressed concern that permitting such outside advisers and consultants to become whistleblowers will harm the free flow of candid advice and information that is necessary to these relationships.[115]

c. Final Rules

After considering the comments, we have made several changes to the exclusions set forth in Rules 21F-4(b)(4)(i) through (vii), which we have renumbered as Rules 21F-4(b)(4)(i) through (vi). We have determined not to extend the exclusions to other outside professionals.

We believe that the exclusions, as modified, are reasonable in scope and consistent with effective enforcement of the securities laws.[116] The exclusions generally apply to narrow categories of individuals whose knowledge does not, in our view, constitute "independent knowledge or analysis *of a whistleblower*," because the

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[115] *See* letters from NACD (advocating excluding individuals hired by boards of directors for purposes of advice and consultation); the Ethisphere Institute (exclusions should extend to external advisers who evaluate corporate ethics and compliance programs); GE Group (should exclude professionals that have relationships of trust and confidence with companies, including investment bankers, financial advisers, compensation consultants, and other consultants); TRACE International, Inc. (noting particular role of outside experts in FCPA compliance efforts, and advocating that exclusions include professionals who are regularly engaged by companies to assist with auditing, creating and implementing robust anti-bribery compliance programs and internal controls, including professionals who perform due diligence on third party relationships as required by the securities laws).

[116] Section 21F does not define the terms "independent knowledge" or "independent analysis," but Section 21F(j) authorizes the Commission to issue rules "to implement the provisions of [Section 21F] consistent with the purposes of [Section 21F]." A substantial purpose of Section 21F is to promote effective enforcement of the securities laws.

information or analysis was acquired by an individual: (1) on behalf of a third party operating in a sensitive legal, compliance, or governance role (exclusions (i), (ii) and (iii)(A)-(C)); or (2) in the performance of an engagement required by the federal securities laws (exclusion (iii)(D)); or (3) by illegal means (exclusion (iv)). Only when one of the exceptions to these exclusions set forth in the rules applies should information acquired in these situations constitute independent knowledge or analysis of the whistleblower.

We believe this result is consistent with the purpose of promoting effective enforcement of the securities laws. Consultation with attorneys can improve compliance on the part of entities and individuals.[117] The recommended exclusions for certain company officials and third parties who assist companies in investigations of possible violations of law are narrowly-focused, and promote the goal of ensuring that the persons most responsible for an entity's conduct and compliance with law are not incentivized to promote their own self-interest at the possible expense of the entity's

[117] A number of comments asserted that, in addition to the attorney-client privilege, any information received in breach of other confidential relationships recognized by common-law evidentiary privileges should be excluded from the definition of independent knowledge. *See, e.g.*, joint letter from Alcoa Inc., Celanese Corporation, Citigroup, Ingersoll-Rand plc, Intel Corporation, Johnson & Johnson, JPMorgan Chase & Co., Kraft Foods Inc., Pfizer Inc., Prudential Insurance Company America, and Tyco International Ltd. ("Alcoa Group"); Auditing Standards Committee; TRACE International, Inc. *But see* letter from NWC (opposing any exclusion for privileged information). Those commenters generally took the position that these relationships have historically been recognized as deserving protection based on public policy considerations, and creating a monetary incentive for those holding this sort of privileged information to divulge it to us is contrary to those public policy considerations. We have determined to exclude (subject to the exceptions set forth in these rules) only information received in breach of the attorney-client privilege, not the other confidential relationships recognized at common-law. Although we recognize the significant public policies underlying all of these confidential relationships, we believe that for purposes of the whistleblower program the attorney-client privilege stands apart because of the significance of attorney-client communications for achieving compliance with the federal securities laws. We will continue to address assertions of other evidentiary privileges through our normal investigative and litigation processes. *See e.g.*, SEC Division of Enforcement Manual § 3.3.1. In addition, contrary to the suggestion from a number of commenters, *see, e.g.*, letter from PricewaterhouseCoopers, LLP ("PwC"), we are not excluding information that is received in breach of state-law confidentiality requirements, such as those imposed on auditors, because to do so could inhibit important federal-law enforcement interests.

ability to detect, address, and self-report violations. The exclusion for auditors performing engagements required by the securities laws reflects the fact that these individuals occupy a special position under the securities laws to perform a critical role for investors. Further, as adopted, our rule permits such individuals to become whistleblowers under certain circumstances.[118]

Finally, although we recognize the important role that outside advisers and consultants play in many aspects of corporate policy and decision-making, we believe that additional exclusions for such professionals would too broadly preclude individuals with possible inside knowledge of violations from coming forward to assist the Commission in identifying and prosecuting persons who have violated the securities laws.

*(a) Attorney-client privilege and other attorney conduct*

a. Proposed Rule

As proposed, Rule 21F-4(b)(4)(i) excluded from the definition of "independent knowledge" or "independent analysis" information that was obtained through a communication that is subject to the attorney-client privilege. In addition, Proposed Rule 21F-4(b)(4)(ii) excluded from the definition of "independent knowledge" or "independent analysis" information that a potential whistleblower obtained as the result of the legal representation of a client on whose behalf the whistleblower's services, or the services of his or her employer or firm had been retained, unless the disclosure had been authorized as stated above. Neither of these exclusions applied where an attorney is permitted to disclose otherwise privileged information; for example, if the

[118] *See* Rule 21F-4(b)(4)(vi). The exclusions for information obtained in violation of federal or state criminal law and for information obtained from excluded sources are discussed below.

privilege has been waived or if the disclosure is permissible pursuant to the Commission's attorney conduct rules[119] or applicable state statutes or bar rules governing the ethical behavior of attorneys.[120]

The proposed exclusions in 21F-4(b)(4)(i) and (ii) recognized the prominent role that attorneys play in all aspects of practice before the Commission and the special duties they owe to clients. We observed that compliance with the federal securities laws is promoted when individuals, corporate officers, and others consult with counsel about possible violations, and the attorney-client privilege furthers such consultation.[121] This important benefit could be undermined if the whistleblower award program created monetary incentives for counsel to disclose information about possible securities violations in violation of their ethical duties to maintain client confidentiality.[122]

The proposed exceptions for information obtained through privileged attorney-client communications and for information obtained in the legal representation of others

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[119] 17 CFR 205.3(d)(2). This Commission Rule permits attorneys representing issuers of securities to reveal to the Commission "confidential information related to the representation to the extent the attorney reasonably believes necessary" (1) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer, in a Commission investigation or administrative proceeding, from committing perjury, suborning perjury, or committing any act that is likely to perpetrate a fraud upon the Commission; or (3) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

[120] *E.g.*, California Evidence Code § 956 ("There is no privilege under this article if the services of the lawyer were sought or obtained to enable or aid anyone to commit or plan to commit a crime or plan to commit a crime or fraud.").

[121] *See Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981) ("[The attorney-client privilege's] purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.").

[122] *United States of America ex rel Fair Laboratory Practices Associates v. Quest Diagnostics, Inc.*, 2011 WL 1330542 (S.D.N.Y. Apr. 5, 2011) (emphasizing "the great federal interest in preserving the sanctity of the attorney-client relationship," the court dismissed a False Claims Act *qui tam* action brought by a partnership where the suit was based on attorney-client privileged information that one of the relator's partners, an attorney, disclosed in violation of New York's attorney ethics laws).

did not apply, however, where the attorney is already permitted to disclose the substance of a communication that would otherwise be privileged. This included, for example, circumstances where the privilege has been waived, or where disclosure of confidential information to the Commission without the client's consent is permitted pursuant to either 17 CFR §205.3(d)(2) or the applicable state bar ethical rules.[123]

The exclusions did not preclude an individual who has independent knowledge of facts indicating possible securities violations from becoming a whistleblower if that individual chooses to consult with an attorney. Facts in the possession of such an individual do not become privileged simply because he or she consulted with an attorney.

b. Comments Received

The Commission received a number of comments related to the exclusions set forth in Proposed Rules 21F-4(b)(4)(i) and (ii). Most commenters were generally supportive of the exclusions for the reasons that we identified in our proposing release.[124] A few commenters, however, asserted that the exclusions are unnecessary,

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[123] *See* Model Rules of Professional Conduct 1.6(b), 1.13(c). Model Rule 1.6(b), variants of which have been adopted by nearly every state in the country and the District of Columbia, permits the disclosure of information relating to the representation of a client, among other things, where the lawyer reasonably believes the disclosure is necessary (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; and (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services. *See* Model Rule 1.6(b)(1)-(3). Model Rule 1.13(c) provides that where an attorney reports violations of law to the highest authority within an organization, and "despite the lawyer's efforts...the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization," the lawyer may reveal information relating to the representation., notwithstanding Rule 1.6, but only to the extent "the lawyer reasonably believes necessary to prevent substantial injury to the organization."

[124] *See, e.g.*, letters from NSCP; Grohovsky Group.

and that instead we should rely upon judicial decisions and state bar opinions to decide on a case-by-case basis whether we could use information that would otherwise be covered by the proposed exclusions.[125]

Many commenters who were generally supportive of the exclusions suggested modifications.[126] Several commenters recommended that the exclusions expressly apply to all information coming from communications subject to the attorney-client privilege, whether or not the whistleblower was an attorney, because non-attorneys are often in possession of information that is subject to the privilege.[127] Other commenters wanted us to modify the rules to ensure that we are not receiving privileged information.[128] For example, one commenter requested that the rule explicitly state that we are not seeking privileged information, and, that if such information is provided to us, we will not argue that the privilege was waived.[129] Other commenters recommended that the rule should exclude all information coming from communications with attorneys, even if the privilege had been waived.[130]

One commenter recommended that we narrow the scope of the exclusions so that, if the privileged information relates to an entity's wrong-doing and the entity does

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125 *See, e.g.*, letters from TAF; Stuart D. Meissner, LLC.

126 *See, e.g.*, letters from M.J. O'Loughlin; joint letter from Apache, Cardinal Health, Goodyear, HP, Merck, Microsoft, Proctor & Gamble, TRW, United Technologies ("Apache Group"); Financial Services Roundtable; and GE Group; Arent Fox LLP; CCMC.

127 *See* letters from Apache Group; Financial Services Roundtable; and GE Group.

128 *See, e.g.*, letters from Arent Fox LLP; CCMC.

129 *See* letter from Apache Group.

130 *See* letter from NACD. *See also* letter from Eric Dixon, LLC.

not appropriately handle the information, a whistleblower will be eligible for an award if he submits it to us.[131]

c. Final Rule

After reviewing the comments, we are adopting proposed Rules 21F-4(b)(4)(i) and (ii) with several modifications.[132]

First, we have modified the language to clarify that both exclusions apply to non-attorneys. Thus, if an attorney in possession of the information would be precluded from receiving an award based on his or her submission of the information to us, a non-attorney who learns this information through a confidential attorney-client communication would be similarly disqualified. Correspondingly, if an attorney could submit the information to us under the same circumstances consistent with applicable state bar rules (*e.g.*, based on waiver of the privilege or a crime-fraud exception), then a non-attorney would similarly be eligible for an award for disclosing the information.

Second, we have modified Rule 21F-4(b)(4)(ii) to clarify that it applies to attorneys who work in-house for an entity and provide legal services (*e.g.*, attorneys in an entity's general counsel's office). The proposing rule may have been unclear about whether in-house attorneys would be covered by Rule 21F-4(b)(4)(ii) because language in the rule stated that the individual's services, or the services of his or her employer or firm, need to "have been retained." Additional ambiguity was created by proposed Rule

[131] Letter from the Institute of Internal Auditors.

[132] In addition, we made several stylistic changes to Rules 21F-4(b)(4)(i) and (ii) that do not affect the substance of either provision. We have replaced "authorized" with "permitted" in stating that attorney-client privileged information, or information learned from the legal representation of a client, may qualify as independent knowledge if its disclosure "would otherwise be permitted by an attorney." *See* letter from M.J. O'Loughlin. We have also moved the phrase "If you obtained the information" from Proposed Rule 21F-4(b)(4) into both Rules 21F-4(b)(4)(i) and (b)(4)(ii).

21F-(4)(b)(4)(iv), which would have created a separate exclusion for individuals who have "legal" responsibilities for an entity. The changes to the final rule clarify our intention that *all* attorneys – whether specifically retained or working in-house – are eligible for awards only to the extent that their disclosures to us are consistent with their ethical obligations and our Rule 205.3.

With regard to the comments that we ensure that whistleblowers are not providing us with privileged information, we believe that Rules 21F-4(b)(4)(i) and (ii) sufficiently address this concern because these rules make clear that we will not reward attorneys or others for providing us with information that could not otherwise be provided to us consistent with an attorney's ethical obligations and Rule 205.3.[133] While some comments suggested expanding[134] or narrowing[135] the exclusions in Rules 21F(B)(4)(i) and (ii), we believe that the final rule strikes the right balance because these exclusions are consistent with the public policy judgments that have been made as to when the benefits of permitting disclosure are justified notwithstanding any potential harm to the attorney-client relationship.

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[133] We have, however, modified Form TCR to ask whether the whistleblower's submission relates to an entity of which the whistleblower is or was a "counsel." *See* Form TCR, Item D5a. In addition, we modified Item 8 on proposed form TCR to ask the whistleblower to identify with particularity any information submitted by the whistleblower that was obtained from an attorney or in a communication where an attorney was present. These questions will enhance the staff's ability to identify the risk of receiving privileged information and provide an appropriate way to balance the Commission's interest in receiving information with the policy goal of protecting the privilege. In addition, knowing this information may allow the staff to quickly segregate potentially privileged information for more detailed review and consideration.

[134] *See, e.g.*, letter from NACD (suggesting that Rule 21F-4(b)(4)(i) exclude all information coming from communications with attorneys, even if the privilege had been waived).

[135] *See, e.g.*, letter from Institute of Internal Auditors (suggesting the exclusion for information subject to the attorney-client privilege should be conditioned on the company in question having investigated and reported the violation in question, so that if the entity does not appropriately handle the information, an individual should be able to report the violation and participate in any whistleblower award).

Nor do we agree with the comments suggesting that the exclusions are unnecessary because even if we receive attorney-client privileged information we can thereafter rely upon judicial opinions and ethics decisions to determine whether we can use it.[136] In our view, the exclusions send a clear, important signal to attorneys, clients, and others that there will be no prospect of financial benefit for submitting information in violation of an attorney's ethical obligations.

*(b) Responsible company personnel, compliance processes, and independent public accountants*

As proposed, Rule 21F-4(b)(4)(iii) excluded independent public accountants who obtained information through an engagement required under the federal securities laws in certain circumstances. Proposed Rules 21F-4(b)(4)(iv) and (v) provided that certain responsible company officials and others who learned information through or in relation to a company's processes for identifying and addressing possible violations of law would not be able to use that information as the basis for a whistleblower submission, subject to certain exceptions set forth in the rules. We have made substantial changes to the proposed rules. As modified, we are adopting these provisions as Rules 21F-4(b)(4)(iii) and (v).

*(i) Proposed Rule 21F-4(b)(4)(iii)*

a. Proposed Rule

Proposed Rule 21F-4(b)(4)(iii) excluded from the definition of "independent knowledge" or "independent analysis" information that was obtained through the performance of an engagement required under the securities laws by an independent

[136] *See* letters from TAF; NSCP.

public accountant, if that information related to a violation by the engagement client or the client's directors, officers or other employees. This proposed exclusion would have applied only if the information related to a violation by the engagement client or the client's directors, officers or other employees.

b. Comments Received

We received many comments related to this rule. Several commenters submitted substantially similar comments about the proposed rule.[137] Generally these commenters recommended expanding the statutory exclusion to disqualify submissions that identified violations in connection with the firm's own conduct,[138] as well as through the performance of non-audit services for audit clients,[139] and audit or other services for non-public clients.[140] These commenters cited to duties of confidence and reporting requirements to which independent public accountants are subject under state law and professional conduct codes, the importance of candor in the audit relationship, and practical problems associated with permitting employees of accounting firms to become whistleblowers in some relationship contexts but not in others.

One commenter urged that the exclusion for independent public accountants should also extend to information obtained by internal company personnel in connection with their role supporting an independent public accountant conducting an audit required under the securities laws."[141]

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[137] Letters from PwC; Ernst & Young; KPMG; the Center for Audit Quality.

[138] Letters from PwC; Ernst & Young; KPMG.

[139] Letters from PwC; Deloitte & Touche, LLP ("Deloitte"); KPMG.

[140] Letters from PwC; Deloitte; KPMG.

[141] Letter from ABA.

One commenter similarly urged that the exclusion be extended to all employees who provide information at the request of auditors (both independent and internal) and observed that under the proposed rule company accountants providing information at the request of external auditors will still be considered to have "independent knowledge and 'independent analysis."[142]

Another commenter expressed the view that independent public accountants (as well as attorneys) should be permitted to become whistleblowers, but with certain limitations.[143] This commenter pointed out that a junior member of the team may not be able to effect change within a client if the senior members are unwilling to oppose management. According to this commenter, auditors and attorneys should be required to report violations internally first, have the ability to do so anonymously, and then be permitted to make a whistleblower submission to the Commission 75 days after making an internal report (but not later than 90 days after their report) if the entity does not respond appropriately.

One commenter was concerned about circumstances where an independent public accounting firm might violate its duties to report under Exchange Act Section 10A.[144] This commenter argued that proposed Rule 21F-4(b)(4)(iii) should be revised to permit whistleblowing when information about illegal acts is not reported to the Commission by the client or the public accounting firm within the time periods specified in Section 10A.

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[142] Letter from NACD.

[143] Letter from DC Bar.

[144] Letter from TAF.

Finally, as noted above, a number of commenters strongly objected in principle to all of our efforts to create exclusions from independent knowledge that are not expressly set forth in Section 21F, including those for independent public accountants.[145]

*(ii) Proposed Rules 21F-4(b)(4)(iv) and (v)*

a. Proposed Rules

Proposed Rule 21F-4(b)(4)(iv) excluded from the definitions of "independent knowledge" and "independent analysis" information obtained by a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity if the information was communicated to that person with the reasonable expectation that he or she would take appropriate steps to cause the entity to respond to the violation. Proposed Rule 21F-4(b)(4)(v) excluded information that was otherwise obtained from or through an entity's legal, compliance, audit, or similar functions or processes for identifying, reporting, and addressing potential non-compliance with applicable law. Each rule was subject to an exception that made the exclusion inapplicable if the entity did not disclose the information to the Commission in a reasonable time, or proceeded in bad faith.

As we explained in our Proposing Release, the rationale for these proposed exclusions was our interest in not implementing Section 21F in a way that created incentives for responsible persons who are informed of wrongdoing, or others who obtain information through an entity's legal, audit, compliance, and similar functions, to circumvent or undermine the proper operation of the entity's internal processes for responding to violations of law. We were concerned about creating incentives for

[145] Letters from NWC; NCCMP; Stewart D. Meissner, LLC; TAF.

company personnel to seek a personal financial benefit by "front running" internal investigations and similar processes that are important components of effective company compliance programs. On the other hand, we proposed that these exclusions would no longer apply if the entity did not disclose the information to the Commission within a reasonable time or proceeded in bad faith, thereby making an individual who knew this information eligible to become a whistleblower based upon his or her "independent knowledge" of the violations.

b. Comments Received

We received many comments expressing sharply different views on these rules. Several commenters expressed strong opposition to the proposed rules. Among other things, these commenters said that the proposed rules would preclude submissions from large numbers of individuals who were in the best position to know about misconduct at companies; that such deference to internal compliance processes is not warranted; that compliance and audit officials may be subject to retaliation, in particular in cases where senior management is implicated in wrongdoing; that the proposed rules were overly broad in their potential application to all supervisors and all employees who had any exposure to compliance and related processes even if the employee had other sources of knowledge; and that the exceptions to the proposed rules suffered from a lack of clarity that would make them unworkable in practice and would strongly discourage potential whistleblowers.[146]

Other commenters generally supported these exclusions in concept, but offered numerous and varied suggestions for expanding, clarifying, or modifying the proposed

[146] *See* letters from NWC; Stuart D. Meissner, LLC; Daniel J. Hurson; TAF; POGO; and Mark Thomas.

rules. For example, some recommended broadening the exclusions to encompass other categories of employees, or clarifying that the proposed rules would cover specific functions, including operations, finance, technology, credit, risk, and similar internal control functions; product management or other personnel responsible for independent valuations of positions at financial services firms; persons who perform the designated functions at subsidiaries or other units of an entity; persons involved in processes relating to required officer certifications and management disclosures under Sections 302, 404, and 906 of the Sarbanes-Oxley Act; and persons performing or supporting an internal audit function, including those individuals who may perform the functions of internal audit but whose job titles and responsibilities may differ.[147]

Commenters also offered different views on the exceptions to the proposed rules permitting use of the excluded information if the entity failed to disclose the information to the Commission within a reasonable time or acted in bad faith. A number of commenters argued against the exceptions and in favor of an absolute preclusion of persons in the designated categories from becoming whistleblowers. These commenters generally took the view that the persons described in Proposed Rules 21F-4(b)(4)(iv) and (v) should promote a culture of compliance and should be required to utilize internal procedures and systems to address and report instances of noncompliance in all circumstances.[148] Certain other commenters recommended that our rules provide that persons who have a legal, compliance, or similar function in a

[147] *See* letters from ABA; SIFMA; Davis Polk; NSCP; and NACD.

[148] *See* letters from Davis Polk; Jones Day; National Association of Criminal Defense Lawyers; Paul, Hastings, Janofsky & Walker LLP ("Paul Hastings"); Financial Services Roundtable; Alcoa Group; Michael Davis; Les M. Taeger; AT&T Inc.; Eric Dixon, LLC; Valspar; joint letter from Joseph Murphy, Esq., Donna Boehme, Esq., Rebecca Walker, Esq. ("Murphy"); Ethisphere Institute.

company would be ineligible for an award unless they have first reported the information to an entity's chief legal officer, chief compliance officer, or a member of the board of directors.[149]

A number of commenters took issue with the "reasonable time" language in Proposed Rules 21F-4(b)(4)(iv) and (v) and suggested alternative approaches for determining when persons described in the rules might be permitted to make whistleblower submissions.[150] Many of these commenters argued that the "reasonable time" standard would, in practice, require companies to disclose all allegations of wrongdoing, regardless of considerations such as the materiality or credibility of the allegations, or the results of the company's investigation. Others pointed out that, because the standard lacked clarity, it would be difficult for persons in these categories to determine whether the company had disclosed the violation and whether it had done so within a "reasonable time." Some commenters recommended that we define a "reasonable time" as some fixed period; e.g., 90-180 days.[151]

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[149] *See* joint letter from U.S. Chamber of Commerce, Americans for Limited Government, Ryder Systems, Inc. Financial Services Institute, Inc., Verizon, White & Case, LLP ("Chamber of Commerce Group"); letters from AT&T; National Association of Criminal Defense Lawyers and Apache Group; *see also* letter from DC Bar (suggesting that individuals in these categories be required to report violations internally first and wait 75 days for the entity to respond appropriately before they are eligible to become whistleblowers.)

[150] *See* letters from ABA (eliminate "reasonable time" standard and only permit use of information in the event of bad faith); Society of Corporate Secretaries (same); DC Bar (require individuals in these categories to report violations internally first and wait 75 days for the entity to respond appropriately before they are eligible to become whistleblowers.); Cleary Gottlieb Steen & Hamilton LLP (replace "reasonable time" with "reasonable and appropriately substantiated basis for believing that the company has failed to remediate the alleged problem or has acted in bad faith"); Apache Group (permit compliance personnel to become whistleblowers if company failed to investigate and remediate, including consideration of whether to self-report, within a reasonable time); Chamber of Commerce Group (permit personnel in these categories to use information only after reporting internally, and if company failed to disclose information concerning substantiated violations in a reasonable time).

[151] *See* letters from Patrick Burns, NACD, John G. Connolly, Auditing Standards Committee, Financial Services Roundtable.

Finally, commenters from diverse perspectives shared the view that aspects of the proposed rules were vague and open to subjective interpretations. Some believed that the lack of clarity could have the effect of discouraging potential whistleblowers because they would not want to risk their livelihoods and reputations in the face of uncertainty concerning whether they might be eligible for an award.[152] However, others suggested that vagueness would encourage persons in the categories designated in the proposed rules to make their own subjective determinations (for example, of whether a "reasonable time" had passed), and would therefore prove disruptive to internal compliance mechanisms.[153]

*(iii) Final Rules 21F-4(b)(4)(iii) and (v)*

After considering the comments, we are adopting the proposed rules with substantial modifications. These provisions have been combined and are now set forth in Rules 21F-4(b)(4)(iii) and (v).

As adopted, Rules 21F-4(b)(4)(iii)(A) through (C) address responsible company personnel with compliance-related responsibilities. Rule 21F-4(b)(4)(iii)(D) (in conjunction with Rule 21F-8(c)(4), discussed below) addresses independent public accountants.[154] Rule 21F-4(b)(4)(v) sets forth exceptions that apply to these exclusions. These rules are discussed separately below.

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[152] *See* letters from TAF, DC Bar, Daniel J. Hurson, Stuart D. Meissner LLC.

[153] *See* letters from ABA, Financial Services Roundtable, Society of Corporate Secretaries, Protiviti, Alcoa Group.

[154] We are addressing independent public accountants through the rules noted above instead of adopting proposed Rule 21F-4(b)(4)(iii). Paragraph (D) of Rule 21F-4(b)(4)(iii), discussed below, excludes from the definition of independent knowledge or analysis information that an accountant learns because of his work on an engagement required under the federal securities laws unless certain enumerated exceptions apply. Rule 21F-8(c)(4) makes a whistleblower ineligible from being considered for an award if the information is gained through an audit of financial statements required under the securities laws and the

a. *Rules 21F-4(b)(4)(iii)(A) through (C)*

As discussed above, we believe there are good policy reasons to exclude information from consideration as "independent knowledge" or "independent analysis" in the hands of certain persons, and in certain circumstances, where its use in a whistleblower submission might undermine the proper operation of internal compliance systems. At the same time, we do not think it serves the purposes of Section 21F to apply this principle in a manner that creates expansive new exclusions for broad categories of company personnel (*e.g.*, any supervisor, or any employee involved in control functions or in processes related to required CEO and CFO certifications). Instead, we believe that the better approach, and one consistent with Congressional intent, is to adopt more tailored exclusions for "core" persons and processes related to internal compliance mechanisms, and to enhance the incentives for employees to report wrongdoing through their company's established internal procedures.[155]

In addition, we agree with the commenters who stated that greater clarity in these rules will assist both whistleblowers and companies. For this reason, we have identified by title or function specific categories of personnel to whom the rules apply.

Thus, as adopted, Rules 21F-4(b)(4)(iii)(A) through (C) describe three categories of persons whom we will not treat as having "independent knowledge" or "independent

submission is "contrary to the requirements of Section 10A..." as provided for in Section 21F(c)(2)(C) (15 U.S.C. §78u-6(c)(2)(C)). After considering the competing views of commenters, we believe these provisions, taken together, strike a balance between the statute's goal of encouraging high quality submissions by whistleblowers and a policy of preventing auditors from getting a windfall from performing their duties.

155 With respect to enhanced incentives, as discussed below, we are adopting a rule that creates additional opportunities for employees to obtain whistleblower awards by reporting information through a company's internal whistleblower, legal, or compliance mechanisms before or at the same time that they file a whistleblower submission with us. *See* Rule 21F-4(c).

analysis" for purposes of a whistleblower submission, unless one of the exceptions listed in paragraph (b)(4)(vi) applies.[156] The first category, set forth in paragraph (A), is officers, directors, trustees, or partners of an entity if they obtained the information because another person informed them of allegations of misconduct, or they learned the information in connection with the entity's processes for identifying, reporting, and addressing potential non-compliance with law. The term "officer" is defined in Rule 3b-2 under the Exchange Act,[157] and means "a president, vice president, secretary, treasurer or principal financial officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated." For example, a managing member of a limited liability company who performs these types of functions would ordinarily fall within this rule.

This provision combines and modifies several concepts that were previously included in Proposed Rules 21F-4(b)(4)(iv) and (v). As noted, we have identified with greater specificity the persons who are covered by the rule. Further, instead of making the exclusion applicable when information is communicated to one of these persons "with the reasonable expectation that [the recipient] would take steps to cause the entity to respond appropriately to the violation," the rule applies whenever one of the designated persons is "informed ... of allegations of misconduct." Thus, when an officer or one of the other designated persons receives a report of possible illegal conduct, the rule applies without the recipient having to evaluate the "expectations" of the person

[156] Rule 21F-4(b)(4)(iii) only applies to the extent that an individual is not subject to any of the exclusions set forth in Rules 21F-4(b)(4)(i) or (ii). Thus, for example, if a company officer receives a report that is covered by attorney-client privilege, paragraph (i) would govern use of the information for purposes of our rules.

[157] 17 CFR §240.3b-2.

who made the report.[158] We have also narrowed the scope of the proposed rule by removing non-officer supervisors from the list of designated persons. We agree with those commenters who stated that including all supervisors at any level would create too sweeping an exclusion of persons who may be in a key position to learn about misconduct, and that such an exclusion would not further the purposes of Section 21F.[159]

Paragraph (A) does not preclude officers and the other designated persons from obtaining an award for a whistleblower submission in all circumstances. As noted, the rule applies when someone else informs a person in the designated categories about allegations of misconduct, or the designated individual learns the information in connection with the entity's processes for identifying, reporting, and addressing potential non-compliance with law.[160] Examples include learning about a violation because an employee reports misconduct to the designated person, being informed of an allegation of misconduct that came into the company's hotline, or learning of a report from the company's auditors regarding a potential illegal act. Paragraph (A) is not intended to establish a general bar against officers, directors, and other designated persons becoming whistleblowers any time they observe possible violations at a company or other entity. For example, paragraph (A) does not prevent an officer from becoming

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[158] *See* letter from ABA (noting problem of requiring the recipient of information to ascertain the "reasonable expectation" of the person who reported the information.)

[159] *See* letter from TAF.

[160] The phrase "in connection with the entity's processes for identifying, reporting, and addressing potential non-compliance with law" requires that the officer, director, or other designated individual learn the information through official responsibilities that relate to such processes.

eligible for a whistleblower award if the officer discovers information indicating that other members of senior management are engaged in a securities law violation.

The second category of persons that Rule 21F-4(b)(4)(iii) excludes from the definitions of "independent knowledge" and "independent analysis," as set forth in paragraph (B), are employees whose principal duties involve compliance or internal audit responsibilities, as well as employees of outside firms that are retained to perform compliance or internal audit work for an entity. For example, a compliance officer is subject to the rule whether he or she learns about possible violations in the course of a compliance review or another employee reports the information to the compliance officer. Unlike the proposed rule, the rule does not include a company's lawyers in either of paragraphs (A) or (B), because lawyers are subject to professional obligations in their dealings with clients, and these are specifically addressed in Rules 21F-4(B)(4)(i) and (ii).[161]

Paragraph (C) of Rule 21F-4(b)(4)(iii) excludes information learned by employees or other persons associated with firms that are retained to conduct an internal investigation or inquiry into possible violations of law in circumstances (as noted above), where the information is not already excluded under Rules 21F-4(b)(4)(i) or (ii).

b. *Rule 21F-4(b)(4)(iii)(D)*

Paragraph (D) of Rule 21F-4(b)(4)(iii) excludes information that is learned by employees of, or other persons associated with, a public accounting firm through an audit or other engagement required under the federal securities laws, if that information relates to a violation by the engagement client or the client's directors, officers, or other

[161] *See* letter from SIFMA.

employees. It only applies to those engagements which are not covered by Rule 21F-8(c)(4).

Similar to other provisions under Rule 21F-4(b)(4), we are adopting this new paragraph based on our concern about creating incentives for independent public accountants to seek a personal financial benefit by "front running" the firm's proper handling of information obtained through engagements required under the federal securities laws. Examples include engagements for broker dealer annual audits pursuant to Rule 17a-5 under the Exchange Act[162] and compliance with the custody rule by advisors.[163]

Paragraph (D), however, does not limit an individual from making a specific and credible submission alleging that the public accounting firm violated the federal securities laws or professional standards.[164] If a whistleblower makes such an allegation, and if that submission leads to a successful action against the engagement client, its officers, or employees, then the whistleblower can obtain an award for that action as well. Moreover, this exclusion does not apply whenever the facts and circumstances fall within the scope of exceptions contained in Rule 21F-4(b)(4)(v).

c. *Rule 21F-4(b)(4)(v)*

Rule 21F-4(b)(4)(v) sets forth exceptions to the application of Rule 21F-4(b)(4)(iii). If any one of these circumstances is present, a person in one of the designated categories under Rule 21F-4(b)(4)(iii) may be eligible for a whistleblower

162 *See* § 240.17a-5.

163 *See* § 275.206(4)-2.

164 *See infra* discussion of Rule 21F-8(c)(4).

award using information that is otherwise excluded to that individual by operation of Rule 21F-4(b)(4)(iii).

The first exception to the operation of Rule 21F-4(b)(4)(iii) applies when the designated person has a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors.[165] For purposes of Rule 21F-4(b)(4)(v), in order for a whistleblower to claim a reasonable belief that disclosure of information to the Commission is necessary to prevent the relevant entity from committing substantial harm, we expect that in most cases the whistleblower will need to demonstrate that responsible management or governance personnel at the entity were aware of the imminent violation and were not taking steps to prevent it. In short, the whistleblower must have a reasonable basis for believing that the entity is about to engage in conduct that is likely to cause substantial injury to the financial interests of the entity or investors, and that notification to the Commission is necessary to prevent the entity from engaging in that conduct. In such cases, we believe it is in the public interest to accept whistleblower submissions and to reward whistleblowers – whether they are officers, directors, auditors, or similar responsible personnel – who give us information that allows us to take enforcement action to prevent substantial injury to the entity or to investors.

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165 This provision is similar to the standard that governs the circumstances in which an attorney appearing and practicing before the Commission in the representation of an issuer may reveal confidential information related to the representation without the issuer's consent. *See* 17 C.F.R. §205.3(d). However, we have not included a requirement of a "material violation," as is found in the attorney conduct rule. As most whistleblowers under this provision will not be attorneys, we have decided not to require that they make legal judgments about whether a material violation has occurred, but simply consider whether they have a reasonable basis to believe that a report to the Commission is necessary to prevent conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors.

The second exception to the operation of Rule 21F-4(b)(4)(iii) applies when the designated person has a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation of the misconduct. Our proposed rule included a similar exception for the entity's "bad faith," and the language, as adopted, is intended to make this standard clearer. Thus, for example, an officer or other individual covered by Rule 21F-4(b)(4)(iii) is not subject to the exclusion of that paragraph if he or she has a reasonable basis to believe that the entity is destroying documents, improperly influencing witnesses, or engaging in other improper conduct that may hinder our investigation.

Finally, under the third exception to Rule 21F-4(b)(4)(iii), an officer, director, auditor or one of the other designated persons can become a whistleblower after at least 120 days have elapsed since the whistleblower provided the information to the audit committee, chief legal officer, or chief compliance officer (or their equivalents) of the entity at which the violation occurred, or to his or her supervisor, or since the whistleblower received the information, if he or she received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or his or her supervisor was already aware of the information. As noted above, many commenters criticized as too vague and unpredictable our proposed rule that would have permitted one of the designated persons to make a whistleblower submission if an entity failed to disclose the information to the Commission within a reasonable time. In response to these comments, we have instead adopted an exception that will permit a person in one of the designated categories to become a whistleblower after a fixed period.

The 120-day period begins to run either from the date the whistleblower informed other senior responsible persons at the entity, or his or her supervisor, about the violations, or from the date the whistleblower received the information, if the whistleblower was aware that these other persons already knew of the violations. Thus, an officer, director, or other designated person cannot receive a report of misconduct, and keep silent about it while waiting for the 120-day period to run, in order to become eligible for a whistleblower award.

The inclusion of a fixed 120-day period is intended for the benefit of potential whistleblowers, so that they will have a date certain after which they will no longer be ineligible to make a submission based upon the information in their possession. It is not intended to suggest to entities that they have a 120-day "grace period" for determining their response to the violations. Furthermore, when considering whether and to what extent to grant leniency to entities for cooperating in our investigations and related enforcement actions, the promptness with which entities voluntarily self-report their misconduct to the public, to regulatory agencies, and to self-regulatory organizations is an important factor.[166]

At the same time, it is important to note that this rule is not intended to, and does not, create any new or special duties of disclosure on entities to report violations or possible violations of law to the Commission or to other authorities. The provisions of this rule are solely designed to provide greater specificity to certain types of potential

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[166] *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, SEC Rel. Nos. 34-44969 and AAER-1470 (Oct. 23, 2001) (http://www.sec.gov/litigation/investreport/34-44969.htm.)

whistleblowers about the circumstances in which their submissions will or will not make them eligible to receive an award.

Nor do we intend to suggest that an internal investigation should in all cases be completed before an entity elects to self-report violations, or that 120 days is intended as an implicit "deadline" for such an investigation. Companies frequently elect to contact the staff in the early stages of an internal investigation in order to self-report violations that have been identified. Depending on the facts and circumstances of the particular case, and in the exercise of its discretion, the staff may receive such information and agree to await further results of the internal investigation before deciding its own investigative course. This rule is not intended to alter this practice in the future.

*(c) Rule 21F-4(b)(4)(iv) - Conviction for Violations of Law*

a. Proposed Rule

Proposed Rule 21F-4(b)(4)(iv) excluded from the definition of "independent knowledge" information that a whistleblower obtained by a means or in a manner that violates applicable federal or state criminal law. We explained our preliminary view that a whistleblower should not be rewarded for violating a federal or state criminal law.

b. Comments Received

Comments on this proposal were divided. Several commenters argued that the proposal went too far in excluding information provided by whistleblowers.[167] One commenter explained that the exclusion would raise difficult questions involving state or

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[167] *See, e.g.*, letters from Stuart D. Meissner, LLC; False Claims Act Legal Center; NWC; Kurt Schulzke; Patrick Burns.

federal criminal law, including who would decide whether evidence was gathered in violation of State or Federal criminal law and under what standard of proof."[168]

Another commenter stated that the Government has historically been permitted to use documents without concern for how a whistleblower obtained them as long as the Government did not direct a whistleblower to take documents[169] and there is no reason to bar a whistleblower from obtaining an award if the Government would be permitted to use those documents.

Several commenters were supportive of the exclusion.[170] One, for example, stated that, even if additional securities law violations might be uncovered by illegal acts, the result would be to undermine respect for the rule of law.[171] Another commenter recommended that the exclusion should go beyond domestic criminal law violations to include, among other things, state and federal civil law.[172]

With respect to whether the exclusion should extend to violations of foreign criminal law, comments were divided.[173] One commenter stated that, without such an exclusion, individuals might be encouraged to break the laws of foreign countries by the

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[168] *See* letter from Stuart D. Meissner, LLC.

[169] *See* letter from False Claims Act Legal Center. *See also* letter from Patrick Burns.

[170] *See, e.g.*, letters from the NSCP; the American Accounting Association; GE Group. *See also* letter from Wanda Bond.

[171] *See* letter from the NSCP.

[172] *See* letter from Financial Services Roundtable.

[173] *Compare* letters from Financial Services Roundtable, American Accounting Association, National Society of Corporate Responsibility, TRACE International, Inc. (supporting extending exclusion to violations of foreign law); *with* letters from VOICES, POGO, and Georg Merkl (opposing extending exclusion to violations of foreign law).

prospect of a whistleblower award.[174] Other commenters urged the Commission not to extend the exclusion to violations of foreign criminal laws. One commenter, for example, argued that there may be situations in which a violation of a foreign criminal law is not a violation of a U.S. federal or state law, and that in such situations a whistleblower should be able to obtain an award.[175]

In addition, commenters were sharply divided on whether we should exclude information obtained in violation of a judicial or administrative protective order.[176] Commenters that supported the exclusion expressed concern that trade secrets and other sensitive information might be disclosed if we were to permit awards for information provided in violation of judicial or administrative protect orders.[177] Other commenters expressed a general concern that protective orders are often negotiated between the parties and entered in private litigation as a way to protect proprietary information and should not operate to shield from the Commission information related to securities law violations.[178]

c. Final Rule

After reviewing the comments, we have decided to adopt the proposed rule, renumbered as Rule 21F-4(b)(4)(iv), but with a modification. Under Rule 21F-4(b)(4)(iv), a whistleblower's information will be excluded from the definition of

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174 *See* letter from TRACE International, Inc. *See also, e.g.*, letters from the American Accounting Association; Financial Services Roundtable; NSCP.

175 *See* letter from POGO. *See also* letters from VOICES and Georg Merkl.

176 Pursuant to Rule 21F-17(a), protective orders entered in SRO proceedings may not be used to prohibit parties from providing the Commission with information about a possible securities law violation.

177 *See, e.g.*, letters from Alcoa Group; Financial Services Roundtable; and GE Group.

178 *See, e.g.*, letters from VOICES; Georg Merkl; Patrick Burns.

"independent knowledge" if he or she obtained the information by a means or in a manner that is determined by a domestic court to violate applicable federal or state criminal law.[179]

We continue to believe that this exclusion is consistent with the intent of Congress that the whistleblower award program not be used to encourage or reward individuals for obtaining information in violation of federal or state criminal law—even if the information might otherwise assist our enforcement of the federal securities laws. Nonetheless, we have decided that the exclusion will only apply where a domestic court determines that the whistleblower obtained the information in violation of federal or state criminal law.[180] We believe that federal and state courts are better positioned than we are to determine whether a whistleblower obtained the information in violation of criminal law.

We have determined not to extend the exclusion to cover information obtained in violation of domestic civil or foreign law, or judicial or administrative protective orders. Commenters raise a number of persuasive points supporting and opposing these additional exclusions. With respect to foreign law, we recognize that other countries often have legal codes that vary greatly from our own, and we are not in a position to decide as a categorical rule when it is appropriate to deny an award based on foreign law.[181] With respect to material that may have been obtained in violation of domestic

[179] This exclusion is also supported by Section 21F(c)(2)(B) of the Exchange Act.

[180] If a criminal case is pending or known to be contemplated against a whistleblower, we may defer decision on an award application until the criminal matter is resolved.

[181] While the proposed rule does not extend the exclusion to information obtained or disclosed in violation of foreign law, we recognize that potential whistleblowers in foreign jurisdictions may have obligations to comply with applicable foreign laws. For instance, some foreign jurisdictions impose

civil law, we believe that, on balance, these exclusions would sweep too broadly and be difficult to apply consistently given the patchwork of state and municipal civil laws that might be implicated.

Finally, we find persuasive the comments that protective orders are frequently negotiated between parties to private litigation and are generally intended to protect proprietary information against public disclosure or improper use. It would be against public policy for litigants to obtain a protective order, or to seek enforcement of such an order, for the purpose of preventing the disclosure of information regarding violations of law to a law enforcement agency. For this reason, we have determined not to exclude whistleblowers who provide us with information that an opposing party may contend comes within the scope of a protective order.

*(d) Rule 21F-4(b)(4)(vi) – Information Obtained from Excluded Persons*

Proposed Rule 21F-4(b)(4)(vii) excluded persons from making whistleblower submissions based upon information they obtained from other persons in whose hands the same information would be excluded as "independent knowledge" or "independent analysis." We are adopting the proposed rule with slight modifications to respond to comments and to increase clarity. This provision is now set forth at Rule 21F-4(b)(4)(v).

a. Proposed Rule

The proposed rule provided that we would not treat a whistleblower submission as derived from "independent knowledge" or "independent analysis" if the whistleblower obtained the information on which the submission was based from any of the individuals described in Proposed Rules 21F-4(b)(4)(i) through (vi) (the other exclusion provisions).

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criminal penalties for unlawfully obtaining certain information or for unlawfully disclosing certain information to authorities outside their borders.

b. Comments Received

One commenter expressed the view that the proposed rule effectively created a "hearsay" exception to the whistleblower provisions that could produce unintended results.[182] The commenter offered the example of an employee who overhears a conversation in which a compliance officer admits to participation in a Ponzi scheme. Under the proposed rule, the commenter pointed out, the employee would be ineligible to receive a whistleblower award.

c. Final Rule

After considering the comments, we are adopting a modified version of the rule. As adopted, Rule 21F-4(b)(vi) provides that a submission will not be deemed to be derived from "independent knowledge" or "independent analysis" if the whistleblower obtained the information for the submission from a person who is subject to this section unless the information is not excluded from that person's use, or the whistleblower is providing the Commission with information about possible violations involving that person.

We added the phrase "unless the information is not excluded from that person's use" to the proposed rule in order to clarify that Rule 21F-4(b)(4)(vi) is intended to be purely derivative; *i.e.*, if the person from whom the information was obtained is free to use the information in a submission (for example, pursuant to the exceptions for officers, directors, auditors and others found in Rule 21F-4(b)(4)(v)), then this rule does not bar use of the information. In order to address the potential for the unintended consequence suggested in the comment, we also added the proviso that this exclusion

[182] *See* letter from NWC.

does not apply if the whistleblower is providing information about violations involving the person from whom the information was obtained.

We expect that Rule 21F-4(b)(4)(vi) will work in tandem with the other exclusions set forth in Rule 21F-4(b)(4) to preclude submissions in a limited set of circumstances. Thus, for example, if an employee only learns about possible violations because he or she is interviewed in the course of a company internal investigation, Rule 21F-4(b)(4)(vi) will not permit that employee to file a whistleblower submission claiming the information as his or her "independent knowledge" or "independent analysis."[183] Similarly, if a senior company officer, after receiving a report concerning possible securities violations, gives the information to his or her assistant, the assistant will not be able to seek an award based on the information as long as the officer is barred from doing so.

*6. Rule 21F-4(b)(5) – Original source*

Proposed Rule 21F-4(b)(5) described how we would determine if a whistleblower was the "original source" of information that we received from another source. We are adopting the rule as proposed, with a slight modification to maintain consistency with other rule changes.

a. Proposed Rule

The proposed rule provided that we would consider a whistleblower to be the "original source" of the same information that we obtained from another source if the information satisfied the definition of original information and the other source obtained the information from the whistleblower or the whistleblower's representative. If the

[183] This assumes that the employee learns the information in the interview from an attorney or other person subject to Rules 21F-4(b)(4)(i) or (ii), or from someone subject to Rule 21F-4(b)(4)(iii)(C). Depending on all of the facts and circumstances, the employee could also be directly excluded under Rule 21F-4(b)(4)(i) if the interview is determined to be covered by the attorney-client privilege.

whistleblower claimed to be the "original source" of information provided to us by any of the authorities set forth in Proposed Rule 21F-4(a) (relating to the "voluntary" submission of information), then the whistleblower would be required to have "voluntarily" provided the information to the other authority within the meaning of Proposed Rule 21F-4(a).

The proposed rule also required that the whistleblower establish his or her status as the original source of information to our satisfaction. In the event that the whistleblower claimed to be the original source of information provided to us by one of the authorities set forth in the rule or by another entity (including the whistleblower's employer), the proposed rule further stated that we might seek assistance and confirmation of the whistleblower's status from the other entity.

b. Comments Received

The few comments we received on this proposed rule primarily sought clarification on its application to particular circumstances.

One commenter requested that we clarify the situation in which one person makes a submission based upon information obtained from a second person, and the second person (the original source of the information) later submits the same information.[184] Another commenter noted the potential for inequity that may result if the person who makes the first whistleblower submission is later displaced from award eligibility because the second submitter (*e.g.*, the first person's supervisor) claims to be "the original source" of information submitted by the first person. The commenter expressed concern that the second submitter might obtain the award, to the exclusion of

[184] *See* letter from SIFMA.

the first person, even though the second person may have known about the violations for an extended period, done nothing to stop them, and only made a submission after learning about the first person's submission.[185]

Another commenter suggested we make clear that if an individual reports misconduct through a company's internal compliance or other reporting processes, and the company subsequently self-reports the violations to the Commission, the individual will be eligible for an award as the "original source" of the information reported by the company.[186]

c. Final Rule

After considering the comments, we are adopting Rule 21F-4(b)(5) as proposed with a slight modification to conform to other rule changes. Specifically, we are modifying the list of governmental and other authorities set forth in the rule to conform to the revised list set forth in Rule 21F-4(a) (see discussion above).

In addition, we provide the following clarifications to address the comments. As the language of our rule indicates, if B makes a whistleblower submission based upon information obtained from A, and A later makes his or her own submission of that information, then A will be considered the "original source" of the information (assuming that A establishes his or her status as the original source and that the information otherwise qualifies as "original information").[187]

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185 *See* letter from TAF.

186 *See* letter from Baron & Budd, P.C.

187 This does not by itself mean that an award is due. The submitter must still satisfy all of the other requirements of Section 21F and of our rules, including that the information was submitted voluntarily, it led to a successful Commission enforcement action or related action, and the submitter is not ineligible for an award.

However, A's status as the "original source" of the information does not exclude B from award eligibility. In this example, because B obtained the facts underlying his or her submission from A, and those facts were not derived from publicly available sources, B would also be deemed to have submitted information derived from his or her "independent knowledge." Thus, both submissions could qualify as "original information;" B's because he or she was first to bring the Commission information derived from "independent knowledge," and A's because he or she was the "original source" of information that, as of B's submission, was already known to the Commission.

Further, by virtue of being first-in-time, B may have an advantage over A. If B's submission were sufficiently specific, credible, and timely that it caused us to open an investigation, and if a successful enforcement action resulted, then we would consider whether B's submission "led to" our successful action under the lower standard set forth in Rule 21F-4(c)(1). Correspondingly, if A made his or her submission after we were already investigating the matter that B brought to us, then A's information would be evaluated under Rule 21F-4(c)(2), and A would have to meet the additional requirement that his or her information "significantly contributed" to the success of the action. In this regard, we note that A would also be considered the "original source" of any additional information he or she provided that materially added to our base of knowledge.[188]

An individual can also be the "original source" of information that we receive from an entity, including, for example, other government authorities, the whistleblower's employer, or other entities to which the individual may report misconduct. For example,

[188] *See* Rule 21F-4(b)(6).

an individual would be the original source of information provided to the Commission by his or her employer if the individual reports possible violations in the first instance through his or her employer's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law, the company later self-reports the individual's information to the Commission, and the individual thereafter files a whistleblower submission. In fact, as is further described below, our final rules seek to enhance the incentives for employees to utilize their company's internal reporting systems, and we provide a clear alternate path for persons who do so to be considered eligible for an award if the company later self-reports violations to the Commission as result of the individual's internal report.[189]

*7. Rule 21F-4(b)(6) – Original source; additional information*

a. Proposed Rule

Proposed rule 21F-4(b)(6) addressed circumstances where we already know some information about a matter from other sources at the time that we receive a whistleblower submission related to the same matter. In that case, the proposed rule provided that we would consider the whistleblower to be an "original source" of any information he or she provided that was derived from the whistleblower's independent knowledge or independent analysis, and that materially added to the information already in our possession. As our Proposing Release explained, this standard was modeled after the definition of "original source" that Congress included in the False Claims Act through recent amendments.[190]

[189] *See* Rules 21F-4(b)(7) and 4(c).

[190] 31 U.S.C. 3730(e)(4)(B), Pub. L. No. 111-148 §10104(h)(2), 124 Stat. 901 (Mar. 23. 2010).

b. Comments Received

One commenter suggested that we clarify how we plan to address the situation where one whistleblower provides original information that leads to successful enforcement of an action, and a second whistleblower provides additional information that "materially aids" the enforcement of the same case.[191]

c. Final Rule

After considering the comments, we are adopting Rule 21F-4(b)(6) as proposed. Accordingly, a whistleblower will be deemed to be an "original of source" of information he or she provides that materially adds to the Commission's base of knowledge about a matter. In cases where a second whistleblower voluntarily provides information that materially adds to what we already know about the matter, and assuming that all of the other requirements of our rules are satisfied, we will assess whether the additional information provided by the second whistleblower also led to successful enforcement of our action pursuant to the standards described in Rule 21F-4(c). If so, and if, as a result, we determine that the second whistleblower is also entitled to an award, then we will determine an award allocation among whistleblowers pursuant to the criteria set forth in Rule 21F-6.

*8. 21F-4(b)(7): Original Source: Lookback*

a. Proposed Rule

Proposed Rule 21F-4(b)(7) provided that, if a whistleblower reported the original information to other authorities or people identified in Proposed Rules 21F-4(b)(4)(iv) and (v) (personnel involved in compliance or similar functions, or who are informed about possible violations with the expectation that they will take steps to address them),

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[191] *See* letter from SIFMA.

and the whistleblower within 90 days submitted the same information to the Commission, we would consider that the whistleblower provided the information as of the date of his or her original disclosure to one of these other authorities or people. In proposing this rule in this manner, we were seeking to protect the ability of the whistleblower to pursue internal or other channels to quickly address the violation while ensuring that the Commission receives this critical information in a timely fashion.

b. Comments Received

The Commission received numerous comments suggesting that we extend the lookback period or eliminate it altogether. Commenters suggested that 90 days was not sufficient time for an internal compliance or review program to conduct a sufficiently thorough investigation and suggested extending the period to 120 days, 180 days, or a reasonable period of time.[192] Others, also calling for a longer lookback period or none at all, suggested that the time limit would burden whistleblowers seeking to complete their own investigations and complicate the process.[193] Some commenters suggested that the Commission should coordinate with other authorities to determine timing rather than burden a whistleblower with proving the timing.[194]

c. Final Rule

In response to the almost uniform view of commenters suggesting a longer lookback period, we are modifying the proposed rule to extend the lookback period to 120 days. Thus, a whistleblower who first reports to an entity's internal whistleblower,

[192] *See, e.g.,* letters from Association of Criminal Defense Lawyers, AT&T, Business Roundable Institute for Corporate Ethics ("Business Roundtable"), NSCP.

[193] *See, e.g.,* letters from Georg Merkl, NWC.

[194] *See e.g.* letter from Storch, Amini & Munves PC.

legal, or compliance procedures for reporting allegations of possible violations of law and within 120 days reports to the Commission could be an eligible whistleblower whose submission is measured as if it had been made at the earlier internal reporting date. This means that even if, in the interim, another whistleblower has made a submission that caused the staff to begin an investigation into the same matter, the whistleblower who had first reported internally will be considered the first whistleblower who came to the Commission, assuming that his information was sufficiently specific and credible to have caused the staff to begin an investigation.[195]

We are balancing priorities with the length and existence of this lookback period, each with the ultimate objective of identifying and remedying violations of the federal securities laws quickly. On the one hand, the Commission's primary goal, consistent with the congressional intent behind Section 21F, is to encourage the submission of high-quality information to facilitate the effectiveness and efficiency of the Commission's enforcement program. For this reason, we are not requiring that a whistleblower utilize an available internal compliance program prior to submission to the Commission, and we are not providing for a lookback period as long as requested by some commenters. Because of our strong law enforcement interest in receiving high quality information about misconduct quickly we have chosen a lookback period shorter than the 180 days or more that some commenters requested.

On the other hand, compliance with the federal securities laws is promoted when companies have effective programs for identifying, correcting, and self-reporting unlawful conduct by company officers or employees. The objective of this provision is

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[195] However, in that instance, the other whistleblower would still be considered for an award if his information significantly contributed to the success of our enforcement action. *See* Rule 21F-4(c)(2).

to support, not undermine, the effective functioning of company compliance and related systems by allowing employees to take their concerns about possible violations to appropriate company officials first while still preserving their rights under the Commission's whistleblower program. This objective is also important because internal compliance and reporting systems are essential sources of information for companies about misconduct that may not be securities-related (*e.g.*, employment discrimination or harassment complaints), as well as for securities-related complaints. We believe that the balance struck in the final rule will promote the continued development and maintenance of robust compliance programs. As we noted in our proposing release, we are not seeking to undermine effective company processes for receiving reports on possible violations including those that may be outside of our enforcement interest, but are nonetheless important for companies to address.

The inclusion of this provision is designed for the benefit of whistleblowers by providing a reasonable period of time to make their decisions. As discussed elsewhere in this release, we are not requiring potential whistleblowers to use internal compliance and reporting procedures before they make a whistleblower submission to the Commission. Among our concerns was the fact that, while many employers have compliance processes that are well-documented, thorough, and robust, and offer whistleblowers appropriate assurances of confidentiality, others do not. Thus, there may well be instances where internal disclosures could be inconsistent with effective investigation or the protection of whistleblowers. Ultimately, we believe that whistleblowers are in the best position to assess whether reporting potential securities violations through their companies' internal compliance and reporting systems would be effective.

Nevertheless, as we noted in our proposing release, we expect that in appropriate cases, consistent with the public interest and our obligation to preserve the confidentiality of a whistleblower, our staff will, upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back. The company's actions in these circumstances will be considered in accordance with the Commission's Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions.[196] This has been the approach of the Enforcement staff in the past, and the Commission expects that it will continue in the future. Thus, in this respect, we do not expect our receipt of whistleblower complaints to minimize the importance of effective company processes for addressing allegations of wrongful conduct.[197]

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196 Exchange Act Release No. 44969 (October 23, 2001).

197 *See* Rule 21F-6. In addition, as discussed below, in order to encourage whistleblowers to utilize internal reporting processes, we expect to give credit in the calculation of award amounts to whistleblowers who utilize established internal procedures for the receipt and consideration of complaints about misconduct. And, in determining whether to give a company the opportunity to investigate and report back, we may consider a number of factors, including, but not limited to, information we have concerning the nature of the alleged conduct, the level at which the conduct allegedly occurred, and the company's existing culture related to corporate governance. We may also consider information we have about the company's internal compliance programs, including what role, if any, internal compliance had in bringing the information to management's or the Commission's attention.

*9. Rule 21F-4(c) – Information that Leads to Successful Enforcement*

a. Proposed Rule

As proposed, Rule 21-4(c) explained when we would consider original information to have led to successful enforcement. The Proposed Rule distinguished between information regarding conduct not under investigation or examination and information regarding conduct already under investigation or examination.

For information regarding conduct not under investigation or examination, the Proposed Rule established a two-part test for determining whether the information led to successful enforcement. First, the information must have caused the staff to commence an investigation or examination, reopen an investigation that had been closed, or to inquire into new and different conduct as part of an existing examination or investigation. Second, the information must have "significantly contributed" to the success of an enforcement action filed by the Commission.

For information regarding conduct under investigation or examination, the Proposed Rule provided a significantly higher standard. To establish that information led to successful enforcement, a whistleblower would need to demonstrate that the information: (1) would not have otherwise been obtained; and (2) was essential to the success of the action.

b. Comments Received

Although a few commenters approved of the standards in the Proposed Rule,[198] most stated that the standards were too high, ambiguous, or both.[199] Several

[198] *See* Chris Barnard; American Accounting Association, Auditing Standards Committee.

[199] *See, e.g.*, TAF; VOICES.

commenters criticized the requirement that information not only cause the staff to open an investigation or examination but also that it "significantly contributed" to the success of the action, noting that the "significantly contributed" element is not contained in the statute and is too high a standard.[200] Commenters also expressed concern that the standard would create uncertainty over when awards would be granted, which in turn would make potential whistleblowers less likely to come forward with information.[201] One commenter suggested that we should examine whether the whistleblower has provided "enough information to get the Commission to open an investigation."[202]

Commenters also criticized the proposed standard applicable when there is already an examination or investigation underway, arguing that it would be almost impossible for whistleblowers to show that information would not have otherwise been obtained and was essential to the success of the action.[203] One commenter expressed concern that the standards could result in anomalous outcomes, providing an example where one whistleblower provides a bare-boned tip that causes the staff to open an investigation (but does not "significantly contribute" to the success of the action), and another whistleblower provides a subsequent tip that is a complete roadmap of the case after the investigation has been opened (but the information is not "essential" to the success of the action), yet neither would receive an award.[204]

[200] *See* letters from American Association for Justice; Grohovsky Group; Cornell Securities Law Clinic; TAF; VOICES; NWC.

[201] Letters from TAF; VOICES.

[202] *See* letter from Grohovsky Group.

[203] Letter from VOICES (arguing that, particularly given our funding issues, we should not condition awards on the theoretical possibility that the staff could uncover the evidence).

[204] Letter from Grohovsky Group.

As noted, we requested comment on whether our rules should require whistleblowers to report violations of the securities laws through their internal compliance and reporting systems before submitting the information to us. Comments on this issue were sharply divided. Many commenters strongly supported such a requirement. In particular, commenters argued that we should require internal reporting because doing so will:

1. allow companies to take appropriate actions to remedy improper conduct at an early stage;[205]
2. allow companies to self-report;[206]
3. avoid undermining internal compliance programs and preserve systems companies have installed designed to deter, indentify, and correct violations;[207]
4. allow the whistleblower program to supplement, rather than supersede the internal control requirements under the Sarbanes-Oxley Act of 2002;[208]
5. allow the Commission to preserve its scarce resources by relying upon corporate internal compliance programs;[209]
6. promote a working relationship between the Commission and companies;[210]

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[205] *See* letters from Lum; Chamber of Commerce Group.

[206] *See* letter from Baker, Donaldson, Bearman, Caldewell & Berkowitz ("Baker Donaldson").

[207] *See* letters from Baker Donaldson; Chamber of Commerce Group; Foster Wheeler; Apache Group; Alcoa Group; Allstate Group.

[208] *See* letters from Arent Fox; Alcoa Group.

[209] *See* letter from ALG.

[210] *id.*

7. allow compliance personnel to address conduct that does not yet rise to the level of a violation or is not a violation (based on a misunderstanding of fact or law);[211]

8. increase the quality of tips the Commission receives;[212] and

9. avoid internal investigations being compromised by unwillingness on the part of whistleblowers to participate.[213]

Many other commenters strongly opposed a requirement that whistleblower report internally before reporting to the Commission. Several commenters argued that doing so would:

1. prohibit whistleblowers from reporting fraud directly and immediately to the Commission;[214]

2. be inconsistent with Congressional intent;[215]

3. create unnecessary and improper hurdles for whistleblowers;[216]

4. place whistleblowers at risk of retaliation;[217]

5. result in whistleblowers deciding not to report misconduct;[218]

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[211] *See* letters from Foster Wheeler; Apache Group.

[212] *See* letter from Apache Group.

[213] *See* letter from Apache Group.

[214] *See* letter from NWC.

[215] *See* letters from TAF; POGO. *See also* Letter from Senator Charles Grassley ("requiring whistleblowers to first go through internal compliance programs would be at odds with the law Congress wrote").

[216] *See* letter from TAF.

[217] *See* letters from TAF; Grohovsky Group; POGO.

[218] *See* letters from Grohovsky Group; POGO.

6. eliminate incentives for companies to improve their internal compliance programs.[219]
7. contravene an employee's right to disclose information anonymously and directly to the Commission;[220] and
8. be inconsistent with the DOJ and IRS whistleblower programs.[221]

c. Final Rule

After considering the comments, we have significantly modified Rule 21F-4(c). First, we are persuaded by those commenters who stated that the standards in the Proposed Rule were too high. As such, we have adopted standards that should be easier to satisfy – both for information regarding conduct not under investigation or examination and information regarding conduct already under investigation or examination – in the Final Rule.

Moreover, as further described below, internal compliance programs are not substitutes for rigorous law enforcement. However, we believe that internal compliance programs play an important role. While we are not requiring whistleblowers to report misconduct internally before reporting to us, we agree that the incentives to do so should be strengthened. Accordingly, the Final Rule includes a provision for a new standard applicable to a whistleblower who reports information internally. The details of the final rule are discussed below.

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219 *See* letter from POGO.

220 *See* letters from NWC and Daniel J. Hurson.

221 *See* letters from TAF and NWC.

i. Rule 21F-4(c)(1): Standard for information concerning conduct not under investigation or examination.

We have decided to lower the standard applicable to information that concerns conduct not under investigation or examination. As noted above, the Proposed Rule required that the information must have "significantly contributed" to the success of the action. In the Final Rule, we have deleted "significantly contributed" from the standard. Under the Final Rule, information will be considered to have led to successful enforcement when it is sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brings a successful judicial or administrative action based in whole or in part on the conduct identified in the original information.

We do not anticipate a rigid, mechanical application of this standard. As a general matter, in assessing whether information 'led to' a successful enforcement action, we will examine the relationship between the information in a submission and the allegations in the Commission's complaint filed in the civil action or order filed in the administrative proceeding. Our inquiry will focus on whether the submission identifies persons, entities, places, times and/or conduct that correspond to those alleged by the Commission in the judicial or administrative action. As part of this analysis, we may consider whether, and the extent to which, the information included: (1) allegations that formed the basis for any of the Commission's claims in the judicial or administrative action; (2) provisions of the securities laws that the Commission alleged as having been violated in the judicial or administrative action; (3) culpable persons or entities (as well as offices, divisions, subsidiaries or other subparts of entities) that the Commission named as defendants, respondents or uncharged wrongdoers in the judicial or administrative action; or (4) investors or a defined group of investors that the Commission named as victims or injured parties in the judicial or administrative action.

The Final Rule also states that the information submitted by the whistleblower must be sufficiently "specific, credible and timely" to cause the Commission to commence an investigation or examination. This new language is intended to describe generally the type of information that would cause our staff to open an investigation or examination. While we believe it is appropriate to adopt a lower standard in the Final Rule, due to our limited resources and the high volume of tips that we receive each year, high-quality tips – ones that are specific, credible and timely -- are most likely to lead to a successful enforcement action.

ii. Rule 21F-4(c)(2): Standard for information concerning conduct already under investigation or examination.

We have also decided to lower the standard applicable for information that concerns conduct already under investigation or examination. We agree with the commenters who expressed concern that the standard in the Proposed Rule – that the information would not have otherwise been obtained and was essential to the success of the action – in practice might be too difficult to satisfy. As a result, for information concerning conduct already under investigation or examination, we will find information to have led to successful enforcement when the information "significantly contributed" to the success of our action.

While we continue to believe that the primary focus of the program is to encourage the submission of information regarding conduct not already known to us, we recognize that in some cases information voluntarily provided by a whistleblower can play a vital role in advancing an existing investigation. Thus, a whistleblower will be eligible for an award in a matter already under investigation if his or her information "significantly contributes" to our success. In applying this standard, among other things, we will look at factors such as whether the information allowed us to bring: (1) our successful action in significantly less time or with significantly fewer resources; (2) additional successful claims; or (3) successful claims against additional individuals or entities.

At the same time, we do not want to reward a whistleblower who has obstructed an ongoing investigation in an effort to obtain an award. In this regard, absent extraordinary circumstances, we will not consider information to have "significantly contributed" to the success of our action if: (i) we or some other law enforcement agency has issued a subpoena or other document request, inquiry or demand to an entity or an individual other than the whistleblower; (ii) there is evidence that the whistleblower was aware of the investigative request, inquiry, or demand; and (iii) the whistleblower withheld or delayed providing responsive documents prior to making the related submission to the Commission. This approach is consistent with one of the principal goals of the program: to incentivize whistleblowers to come forward early with information of possible violations of the securities laws rather than wait until they become aware of an investigation by the Commission or other agency.[222] Further, it would not be good policy for a person to be rewarded for "significantly contributing" to the success of an action when he has knowingly obstructed the investigation of the misconduct.

iii. Rule 21F-4(c)(3): Additional incentives to encourage reporting through internal compliance programs.

Paragraph (3) of Rule 21F-4(c) is a new provision that has been added, in response to comments, to create a significant financial incentive for whistleblowers to report possible violations to internal compliance programs before, or at the same time, they report to us. The final rule provides that if: (1) a whistleblower reports original information through his or her employer's internal whistleblower, legal or compliance procedures before or at the same time he or she reports them to the Commission; (2) the employer provides the Commission with the whistleblower's information or with the results of an investigation initiated in response to the whistleblower's information; and (3) the information provided by the employer to the Commission "led to" successful enforcement under the criteria of Rule 21F-4(c)(1) or (2) discussed above, then the whistleblower will receive full credit for the information provided by the employer as if the whistleblower had provided the information to us.[223] Thus, when the employer provided information "led to" a successful enforcement action, the whistleblower will be

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[222] *See* S. Rep. No. 111-176 at 110 (2010) ("The Whistleblower Program aims to motivate those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated securities laws….").

[223] Employees who report internally in this manner will have anti-retaliation employment protection to the extent provided for by Section 21F(h)(1)(A)(iii) of the Exchange Act, which incorporates the broad anti-retaliation protections of Sarbanes-Oxley Section 806, *see* 18 U.S.C. 1514A(b)(2).

eligible for an award, even if the information the whistleblower originally provided to the employer would not have satisfied the "led to" requirements.

To qualify for an award under this new provision, the rule requires that a whistleblower must provide information "through an entity's internal whistleblower, legal or compliance procedures for reporting allegations of possible violations of law." A report to a supervisor will qualify under this standard if the entity's internal compliance procedures require or permit reporting misconduct in the first instance to supervisors. Furthermore, if an entity does not have established internal procedures for reporting violations of law, we will consider an employee who reports a possible violation to the entity's legal counsel, senior management, or a director or trustee to have provided the information through the appropriate "internal whistleblower, legal or compliance procedures."[224]

Rule 21F-4(c)(3) incentivizes whistleblowers to report internally in appropriate circumstances by providing them a meaningful opportunity to increase their probability of receiving an award. In effect, reporting internally provides a second potential path to an award. We anticipate that not only individuals who were pre-disposed to report internally prior to the enactment of the whistleblower award program, but also some who would not have been inclined to report internally, will respond to Rule 21F-4(c)(3)'s financial incentive by utilizing internal reporting procedures. Put differently, the rule's financial incentives should both mitigate any diversion from internal reporting of

[224] To qualify for consideration under Rule 21F-4(c)(3), a whistleblower must establish that he or she provided original information through the appropriate "internal whistleblower, legal or compliance procedures." Accordingly, prospective whistleblowers will be better able to support their claims under this provision if they generate, obtain and retain contemporaneous documentation (e.g., emails or other written records) demonstrating their compliance with the requirements of the Rule, including documents evidencing: (i) the substance of the information; (ii) the means by which the information was provided; (iii) the recipients of the information; and (iv) the date on which the information was provided.

individuals who would be pre-disposed to report internally in the absence of the whistleblower program, and incentivize new individuals who otherwise might never have reported internally to enter the pool of potential internal whistleblowers. As a result, the provision should increase the likelihood that individuals will report misconduct to effective internal reporting programs, allowing such programs to continue to play an important role in facilitating compliance with the securities laws.

Although many commenters argued that we should require whistleblowers to report possible violations internally either before or contemporaneously with reporting to us, we are not persuaded that such a requirement would achieve better overall enforcement of the federal securities laws than the approach we are adopting for several reasons. First, we believe that there are a significant number of whistleblowers who would respond to the financial incentive offered by the whistleblower program by reporting <u>only</u> to the Commission, but who would not come forward <u>either</u> to the Commission or to the entity if the financial incentive were coupled with a mandatory internal reporting requirement.[225] In those cases, the Commission would not receive critical information about possible securities law violations, and companies and investors would suffer harm as on-going violations remained undetected and unremedied.

Second, our approach should encourage companies to continue to strengthen their internal compliance programs in an effort to promote internal reporting. Potential

[225] Specifically, the fear of retaliation and other forms of harassment, as well as other social and psychological factors, can have a chilling effect on certain whistleblowers who, absent a mandatory internal reporting requirement, would respond to the financial incentive offered by the whistleblower program by providing the Commission with information about possible securities law violations. *See* discussion in Part IV(A)(7) of the Economic Analysis. A number of commenters who routinely work with whistleblowers supported this assessment. *See, e.g.*, letters from Grohvosky (explaining that if potential whistleblowers were required to report internally, many would remain silent); TAF (same).

whistleblowers are more likely to respond to Rule 21F-4(c)(3)'s financial incentive by reporting internally when they believe that the company or entity has a good internal compliance program – *i.e.*, a compliance program that will take their information seriously and not retaliate.[226] We anticipate that companies will recognize this, take steps to promote a corporate environment where employees understand that internal reporting can have a constructive result, and that the net effect of this will be enhanced corporate compliance with the federal securities laws.

Third, while internal compliance programs are valuable, they are not substitutes for strong law enforcement. In some cases, law enforcement interests will be better served if we know of potential fraud before the entities or individuals involved learn of our investigation. This is particularly true when there is a risk that an entity or individual may try to hinder or impede our investigation by, for example, destroying documents or tampering with witnesses.[227] Similarly, there are circumstances where a whistleblower may have legitimate reasons for not wanting to report the information internally, for example, legitimate concerns about misconduct by the company's management or within the internal compliance program, or a reasonable basis to fear retaliation or personal harm.

In addition, we do not believe that a general requirement on whistleblowers to report possible violations through internal compliance procedures would be consistent

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[226] *See generally* Richard E. Moberly, Sarbanes-Oxley's Structural Model To Encourage Corporate Whistleblowers, 2006 BYU L. REV. 1107, 1144 (2006).

[227] Similarly, we note that a requirement for mandatory internal reporting before reporting to the Commission would result in undesirable outcomes in the case of entities' with ineffective internal compliance processes. In these cases, mandatory internal pre-reporting would lead to unnecessary delays before the violation can be addressed by the Commission, resulting in potentially increased injuries to the company and investors.

with the language of, or legislative intent underlying, Section 21F. As evidenced by the text of Section 21F, the broad objective of the whistleblower program is to enhance the Commission's law enforcement operations by increasing the financial incentives for reporting and lowering the costs and barriers to potential whistleblowers, so that they are more inclined to provide the Commission with timely, useful information that the Commission might not otherwise have received.[228] However, as discussed above, a general requirement that employees report internally as a condition of participating in the whistleblower program would impose a barrier that in some cases would dissuade potential whistleblowers from providing information to the Commission, contrary to the purpose of the whistleblower provision.[229] Moreover, a mandatory internal reporting requirement would deviate from the operation of other established federal whistleblower award programs, and there is no indication in the text or legislative history of Section 21F that Congress intended that result.[230]

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[228] The statute incentivizes whistleblowers to report possible securities law violations to the Commission by offering them financial awards, reducing the risks from employment retaliation, and lowering the barriers through user-friendly procedures and appellate redress. See Section 21F(b)-(c) of the Exchange Act (10-30% awards); *id.* 21F(d) (whistleblower anonymity); *id.* 21F(e) (no contractual obligations can be imposed on whistleblowers unless provided for in a Commission rule or regulation); *id.* 21(f) (right of appeal); *id.* 21F(h) (anti-retaliation protection and heightened confidentiality requirements for whistleblower identifying information). *See also* Section 922(d) of Dodd-Frank Act (mandating a study of the "whistleblower protections" established in Section 21F of the Exchange Act).

[229] Similarly, an internal reporting requirement would appear inconsistent with the provisions of Section 21F that are designed to protect the identity of a whistleblower. *See* Section 21F(d)(2) & (h)(2). Simply put, even where an entity may have implemented generally effective procedures for anonymous reporting, there will be situations where a whistleblower's tip might, by the nature of the information it discloses, reveal the identity of the whistleblower – *e.g.*, situations where only a few people would have assess to the information. The financial incentives approach that we are adopting allows the whistleblower to access whether an internal report might disclose his identity and, if so, whether he wishes to report internally notwithstanding this possibility.

[230] We also considered suggestions by some commenters that we should require internal reporting by employees of issuers that are subject to Section 301 of the Sarbanes-Oxley Act of 2002 ("SOX") in order to harmonize Section 21F with the requirement of Section 301 that listed companies have audit committee procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting control, and auditing matters, including procedures for the submission of information

At the same time, we also do not agree with the comment that no provisions should be made in our rule to encourage internal reporting because whistleblowers would do so anyway.[231] Although some evidence suggests that many whistleblowers will continue to report misconduct internally,[232] we understand that the financial incentives established by Section 21F could have the potential to divert other whistleblowers away from reporting internally. If this diversion were significant, it might impair the usefulness of internal compliance programs, which can play an important role

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anonymously. *See, e.g.* letters from Business Roundtable; ABA; U.S. Chamber of Commerce Group; Alcoa Group. In Section 301 of SOX, Congress mandated that listed companies establish structural mechanisms to facilitate internal whistleblowing by employees. In Section 21F, however, Congress chose a wholly different model – one that provides financial incentives for employees and others to report violations directly to the Commission. *See* Richard E. Moberly, *Sarbanes-Oxley's Structural Model To Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1107, 1108 n.5 (2006); Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U.L.Rev. 91 (2007). We do not think it appropriate to limit the path opened by Section 21F by a Commission-imposed requirement that employees of listed companies also utilize internal audit committee or other complaint procedures. Further, even if a company has anonymous complaint procedures consistent with Section 301 of SOX, in some cases an anonymous whistleblower's identity can be gleaned from the facts and circumstances surrounding the whistleblower's complaint. In those situations, requiring the whistleblower to report internally would be in tension with the mandate of Section 21F that we protect information that could reasonably be expected to reveal the identity of a whistleblower. *See* Section 21F(h)(2) of the Exchange Act. Finally, as discussed above, we believe that our approach will incentivize individuals who were pre-disposed to report internally to continue to do so, and thus will significantly mitigate the concern of commenters that our rules will undermine internal reporting processes established pursuant to Section 301.

[231] *See, e.g.,* letter from NWC ("NWC strongly urges that the Commission rules be revised and ... treat employees equally whether they choose to make their disclosures internally, externally, or both."). *But cf.* Chamber of Commerce Group ("In the absence of an affirmative restriction on external reporting when effective internal compliance channels are available, *or provision of a significant incentive for using those internal channels*, employees will face an irresistible temptation to go to the SEC with their report.") (emphasis added).

[232] *See* letter from NWC. This comment included a study indicating that roughly 90% of individuals who eventually filed *qui tam* suits under the False Claims Act also reported the misconduct internally, without any incentives for internal reporting. It is not clear that data about whistleblower behavior under the False Claims Act necessarily will be an accurate predictor of behavior under our program. The barriers to participation as a False Claims Act whistleblower are appreciably higher than in our program: for example, to be eligible for an award under the False Claims Act, a *qui tam* relator must file a federal court complaint alleging fraud with specificity as required by Rule 9(b) of the Federal Rules of Civil Procedure, whereas under our program, a whistleblower only needs to complete a Form TCR, sworn under penalty of perjury.

in achieving compliance with the securities laws. Accordingly, we believe that it is appropriate for us to provide significant financial incentives as part of the whistleblower program to encourage employees and other insiders to report violations internally, while still leaving the ultimate decision whether to report internally to the whistleblower.

*10. Rule 21F-4(d) – Action*

Proposed Rule 21F-4(d) defined the term "action" to mean a single captioned judicial or administrative proceeding. We are revising the proposed rule to permit consideration of multiple cases that arise out of a common nucleus of operative facts as a single "action."

a. Proposed Rule

For purposes of calculating whether monetary sanctions in a Commission action exceed the $1,000,000 threshold required for an award payment pursuant to Section 21F of the Exchange Act, as well as determining the collected sanctions on which awards are based,[233] proposed rule 21F-4(d) defined "action" to mean a single captioned civil or administrative proceeding. Under the proposed rule, "action" included all defendants or respondents and all claims brought within that proceeding without regard to which specific defendants or respondents, or which specific claims, were included in the action as a result of the information that the whistleblower provided.

Also, the proposed rule meant that the Commission would not aggregate sanctions that are imposed in separate judicial or administrative actions for purposes of determining whether the $1,000,000 threshold is satisfied, even if the actions arise out of a single investigation. For example, if a whistleblower's submission leads to two

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[233] *See* Proposed Rule 21F-5.

separate enforcement actions, each with total sanctions of $600,000, then no whistleblower award would be authorized because no single action will have obtained sanctions exceeding $1,000,000.

b. Comments Received

Commenters offered competing views on the proposed interpretation of "action." A number of commenters supported our proposed definition.[234] Several commenters disagreed with the proposal, urging that the Commission should aggregate multiple Commission actions arising out of a whistleblower's submission for purposes of satisfying the $1,000,000 threshold[235] because to do otherwise was to put form over substance and not fully reward whistleblowers for the information they provided that led to successful actions.[236]

Two other commenters argued that our definition of "action" should be narrowed so that, in a case involving multiple counts, only the counts resulting from the whistleblower's information are considered.[237] These commenters were concerned that, without this limitation, the rules would encourage whistleblowers to report even minor violations in the hope that they will be grouped with more serious violations in a single action with the result that all of the sanctions in the action together meet the covered action threshold.

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[234] *See* letters from Chris Barnard, Auditing Standards Committee, and Institute of Internal Auditors.

[235] *See,* letters from VOICES, NWC, Stuart D. Meissner, LLC, Georg Merkl, and Wanda Bond.

[236] *See* letter from the NWC.

[237] *See* letters from the NSCP and SIFMA.

c. Final Rule

After reviewing the comments, we are adopting the rule with substantial modifications. Notwithstanding the use of the singular term "action" in Section 21F, we agree with the commenters who urged that Congress did not intend for a meritorious whistleblower to be denied consideration for an award simply because we chose to bring separate proceedings against respondents or defendants involved in the same or closely related conduct.[238]

Accordingly, as adopted, Rule 21F-4(d) defines the term "action" generally to mean a single captioned judicial or administrative proceeding brought by the Commission. However, the rule also identifies two exceptions to this general definition. First, an "action" will constitute two or more Commission proceedings arising from the same nucleus of operative facts for purposes of making an award under Rule 21F-10. Second, for purposes making payments under Rule 21F-14 on a Commission action for which we have already made an award, we will treat as part of that same action any subsequent Commission proceeding that, individually, results in a monetary sanction of $1,000,000 or less, and that arises out of the same nucleus of operative facts.

[238] As noted above, two commenters argued that we should interpret "action" narrowly such that we would only pay an award to a whistleblower for monetary sanctions related to specific counts in an action that were based upon the whistleblower's information. We decline to do so. First, we do not believe that such a narrow interpretation is consistent with the purpose of the whistleblower program, which is to encourage whistleblowers to provide the Commission with information that leads to successful enforcement actions. The proposed narrow interpretation of action would reduce incentives for whistleblowers to provide the Commission with information because (i) it would create uncertainty regarding how monetary sanctions may be assigned to specific counts and (ii) it would not reward whistleblowers who provide the Commission with information regarding lesser misconduct (although misconduct sufficient to cause the Commission to open an investigation) but which led the Commission to uncover much more significant misconduct. Second, we do not believe that such a narrow interpretation of action is practical. In contested actions, courts often do not assign monetary sanctions against a single defendant on a per count basis, and neither do Commission settlements. As such, we would have no reasonable basis to assign specific amounts to various counts in an action.

The same-nucleus-of-operative-facts test is a well-established legal standard that is satisfied where two proceedings, although brought separately, share such a close factual basis that the proceedings might logically have been brought together in one proceeding.[239] In exercising our discretion and deciding whether two or more proceedings arise from the same nucleus of operative facts, we intend to apply a flexible approach and will consider a number of factors, including whether the separate proceedings involve the same or similar: (1) parties (whether named as defendants/respondents or simply named within the complaint or order); (2) factual allegations; (3) alleged violations of the federal securities laws; or (4) transactions or occurrences.[240]

Paragraph (d)(1) allows us to treat together as a covered action for purposes of making an award under Rule 21F-10, two or more administrative or judicial proceedings brought by the Commission if those proceedings arise from the same nucleus of operative facts. So, for example, if we bring multiple proceedings during the course of an investigation, and these proceedings involve the same nucleus of operative facts but none yields a monetary sanction in excess of $1,000,000, we may nonetheless issue a

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[239] *See, e.g., Harper v. AutoAlliance Intern., Inc.*, 392 F.3d 195, 209 (6th Cir. 2004) ("Claims form part of the same case or controversy [for purposes of supplemental jurisdiction] when they 'derive from a common nucleus of operative facts.'") (quoting *Ahearn v. Charter Township of Bloomfield*, 100 F.3d 451, 454-55 (6th Cir. 1996)). To determine whether two or more proceedings involve the same nucleus of operative facts, courts look at "factors such as 'whether the facts are related in time, space, origin or motivation,' 'whether they form a convenient trial unit,' and whether treating them as a unit 'conforms to the parties' expectations.'" *In re Iannochino*, 242 F.3d 36, 46 (1st Cir. 2001) (quoting *Restatement (Second) of Judgments* § 24 (1982)) (internal quotation marks omitted). *See also Airframe Systems, Inc. v. Raytheon Co.*, 601 F.3d 9, 15 (1st Cir. 2010). Put another way, "as long as the new complaint grows out of the same transaction or series of connected transactions as the old complaint, the causes of action are considered to be identical." *Kale v. Combined Ins. Co.*, 924 F.2d 1161, 1166 (1st Cir. 1991) (internal quotation marks and citations omitted).

[240] An administrative or judicial proceeding brought by the Commission will be treated as part of only one covered action.

Notice of Covered Action and treat these proceedings as one covered action for purposes of making an award under Rule 21F-10. Thus, if a qualified whistleblower provided us with original information that led to the successful enforcement of any one of the proceedings, we will make an award to that whistleblower for 10 to 30 percent of the total monetary sanctions collected in those proceedings.

Similarly, we will treat together a proceeding that yielded a monetary sanction of $1,000,000 or less with a Commission proceeding that alone would qualify as a covered action if the two proceedings involve the same nucleus of operative facts. Here again, we believe this is consistent with Congress's intent that qualified whistleblowers who provide us with original information that leads to enforcement proceedings yielding monetary sanctions in excess of $1,000,000 should receive an award payout that fully reflects the monetary sanctions collected.

Paragraph (d)(1) also authorizes us to treat as a covered action under Rule 21F-10 two or more Commission proceedings that otherwise might individually qualify as covered actions where these proceedings involve the same nucleus of operative facts. We believe that treating these proceedings together under the Rule 21F-10 procedures as one covered action, rather than processing them as separate covered actions, will help make the awards procedures more efficient and user-friendly, thereby further encouraging whistleblowers to come forward.

Finally, paragraph (d)(2) provides that, for purposes of determining the payment on an award pursuant to Rule 21F-14, we will deem as part of the Commission action upon which the award was based any subsequent Commission proceeding that, individually, results in a monetary sanction of $1,000,000 or less, and that arises out of the same nucleus of operative facts.[241] For example, if we make a whistleblower award for a covered action brought against an entity, but thereafter bring a separate proceeding against the officer who was responsible for the entity's conduct in which we do not recover in excess of $1,000,000, we may in our discretion determine to treat the second proceeding as part of the previous covered action and provide a payment based on the total of the two proceedings.

*11. Rule 21F-4(e) – Monetary Sanctions*

Proposed Rule 21F-4(e) tracked the definition of "monetary sanctions" found in Section 21F(a)(4) of the Exchange Act to mean any money, including penalties, disgorgement, and interest, ordered to be paid and any money deposited into a disgorgement fund or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002 as a result of a Commission action or a related action.[242] We received no comments on the proposed rule. We are adopting the rule as proposed. As was explained in our Proposing Release, we interpret the reference in Section 21F(a)(4) to "penalties, disgorgement, and interest" to be examples of monetary sanctions, and not exclusive. Thus, regardless of how designated, we will consider all amounts that are "ordered to be paid" in a Commission action or a related action as "monetary sanctions" for purposes of Section 21F.

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[241] If a subsequent Commission proceeding arises from the same nucleus of operative facts as two covered actions for which we have already made awards, we will treat the subsequent proceeding as part of the covered action to which it bears the closest relationship.

[242] 15 U.S.C. 78u-6(a)(4).

*12. Rule 21F-4(f) – Appropriate regulatory agency*

a. Proposed Rule

Section 3(a)(34) of the Exchange Act defines the term "appropriate regulatory agency." Consistent with this definition, the proposed rule defined the term "appropriate regulatory agency" to mean the Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be added to Section 3(a)(34) of the Exchange Act by future amendment.[243] Although Section 3(a)(34) defines the Commission and these other agencies to be "appropriate regulatory agencies" for specified functions and purposes, we stated in our Proposing Release that we would treat these agencies as "appropriate regulatory agencies" for all purposes under these rules. This would mean that, under Section 21F(c)(2)[244] and Rule 21F-8, a member, officer, or employee of one of the designated agencies would be ineligible to receive a whistleblower award even if the information that the person possesses is unrelated to the agency's regulatory function. This interpretation would place members, officers, and employees of appropriate regulatory agencies on equal footing with those of other organizations, such as the Public Company Accounting Oversight Board and law enforcement organizations, who are also statutorily ineligible to receive whistleblower awards.[245]

[243] Title III of Dodd-Frank abolishes the Office of Thrift Supervision and transfers its functions to other agencies one year after the date of enactment, unless the transfer date is extended.

[244] 15 U.S.C. 78u-6(c)(2).

[245] *See* Section 21F(c)(2)(A), 15 U.S.C. 78u-6(c)(2)(A).

b. Comments Received

Two commenters supported our definition.[246] One commenter suggested that, in cases involving auditors, we should treat the PCAOB as an "appropriate regulatory agency."[247]

c. Final Rule

After considering the comments, we are adopting Rule 21F-4(f) as proposed. As Congress placed Section 21F in the Exchange Act, we believe it appropriate to define "appropriate regulatory agency" for purposes of Section 21F consistently with the existing Exchange Act definition of the same term. For this reason, we have determined not to define "appropriate regulatory agency" to include the PCAOB or any other authority not set forth in Section 3(a)(34) of the Exchange Act.

This approach does not inappropriately exclude the PCAOB for any relevant purposes under our rules. Section 21F(c)(2)(A)[248] and Rule 21F-8(c)(1) exclude from award eligibility members, officers, or employees of "appropriate regulatory agencies," and of the PCAOB. Similarly, under Section 21F(h)(2)(D)[249] and Rule 21F-7(a)(2), the PCAOB is separately set forth as an authority with which we may share whistleblower-identifying information.[250]

246 *See* letters from Chris Barnard and Georg Merkl.

247 *See* letter from Auditing Standards Committee.

248 15 U.S.C. §78u-6(c)(2)(A).

249 15 U.S.C. §78u-6(h)(2)(D).

250 However, Section 21F does not permit us to treat PCAOB actions as "related actions" for purposes of payment of an award. *See* Sections 21F(a)(5), 15 U.S.C. 78u-6(a)(5) and 21F(h)(2)(D), 15 U.S.C. 78u-6 (h)(2)(D).

*13. Rule 21F-4(g) – Appropriate regulatory authority*

Rule 21F-4(g) defines an "appropriate regulatory authority" to mean an appropriate regulatory agency other than the Commission.

Section 21F(h)(2)(D)[251] of the Exchange Act provides that, without the loss of its status as confidential in the hands of the Commission, we may provide information that identifies a whistleblower to other authorities set forth in the statute, including "an appropriate regulatory authority." Through the operation of Section 21F(a)(5),[252] we are also directed to pay awards on related actions brought by an "appropriate regulatory authority."

The proposed rules did not include a definition of "appropriate regulatory authority." Instead, we used the defined Exchange Act term "appropriate regulatory agency" for purposes of the provisions dealing with ineligibility for awards, where that term expressly appears,[253] as well as the provisions dealing with sharing of whistleblower-identifying information and awards in connection with related actions, where the statute actually uses the term "appropriate regulatory authority."[254] As a result of this approach, the proposed rules could have been read to mean that an action brought by the Commission was a "related action," even though our intention was to consider only actions brought by authorities other than the Commission as "related actions."

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251 15 U.S.C. 78u-6(h)(2)(D).

252 15 U.S.C. 78u-6(a)(5)

253 Section 21F(c)(2), 15 U.S.C. 78u-6(c)(2); Proposed Rule 21F-8(c).

254 Section 21F(a)(5) and (h)(2)(D)(i), 15 U.S.C. 78u-6(a)(5) and (h)(2)(D)(i); Proposed Rules 21F-3(b) and 21F-7(a)(2).

In response to comments, and as discussed above, we have revised our definition of "action" in order to provide for payment of awards on additional Commission enforcement actions that might otherwise have qualified as "related actions" under a literal reading of the proposed rules. As a result of that revision, there is no other reason to treat the Commission as an "appropriate regulatory authority" for the purposes set forth in the statute. Accordingly, in order to avoid confusion and to establish a single consistent route to payment of an award based on Commission enforcement actions, we have determined to adopt a separate definition of the term "appropriate regulatory authority" that excludes the Commission.[255]

*14. Rule 21F-4(h) – SRO*

Proposed Rule 21F-4(g) defined the term "self-regulatory organization" to mean any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board, and any other organizations that may be defined as self-regulatory organizations under Section 3(a)(26) of the Exchange Act. As was explained in our Proposing Release, Section 3(a)(26) includes each of these organizations as a "self-regulatory organization," except that the Municipal Securities Rulemaking Board is designated as a self-regulatory organization solely for purposes of Sections 19(b) and (c) of the Exchange Act (relating to rulemaking).[256] Consistent with the approach taken with regard to the definition of "appropriate regulatory agency" (see discussion above), Proposed Rule 21F-4(g) would make clear

[255] As noted, Section 21F(h)(2)(D) provides that, "without the loss of its status as confidential in the hands of the Commission," we may provide whistleblower-identifying information to "an appropriate regulatory authority." Thus, it seems clear that for that purpose the term "appropriate regulatory authority" must apply to entities other than the Commission.

[256] 15 U.S.C. 78s(b) and (c).

that the Municipal Securities Rulemaking Board is considered to be a "self-regulatory organization" for all purposes under Section 21F.

The few commenters on this proposal all supported it.[257] We are adopting Rule 21F-4(g) as proposed, but re-designating it as Rule 21F-4(h).

E. <u>Rule 21F-5 - Amount of Award</u>

a. Proposed Rule

Proposed Rule 21F-5 stated that, if all conditions are met, the Commission will pay an award of at least 10 percent and no more than 30 percent of the total monetary sanctions collected in successful Commission and related actions. This is the range that is specified in Section 21F(b)(1) of the Exchange Act.

b. Comments Received

We received few comments on this section. One commenter, a Member of Congress, suggested that we should consider placing an upper-end limit on the dollar amount that any one whistleblower could receive to avoid giving excessive awards.[258] Another commenter suggested that we should give further guidance on how award percentages would be determined as between Commission and related actions.[259]

c. Final Rule

We are adopting the final rule as proposed, except that we have added a new paragraph (a) to reflect Congress's clear direction that the determination of the amount of an award lies in our discretion.[260]

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[257] *See* letters from Auditing Standards Committee, Georg Merkl, and Chris Barnard.

[258] Letter from Senator Carl Levin.

[259] Letter from Auditing Standards Committee, Institute of Internal Auditors.

[260] *See* Section 21F(c)(1)(A), 15 U.S.C. 78u-6(c)(1)(A).

Paragraph (b) of Section 21F of the Exchange Act states that the Commission will independently determine the appropriate award percentage for each whistleblower, but total award payments, in the aggregate, will equal between 10 and 30 percent of the monetary sanctions collected in the Commission's action and the related action. Our final rule tracks this provision. Thus, for example, one whistleblower could receive an award of 25 percent of the collected sanctions, and another could receive an award of 5 percent, but they could not each receive an award of 30 percent. As we noted in our proposed rule, since the Commission anticipates that the timing of award determinations and the value of a whistleblower's contribution could be different for the Commission's action and for related actions, the proposed rule would provide that the percentage awarded in connection with a Commission action may differ from the percentage awarded in related actions. But, in any case, the amounts would, in total, fall within the statutory range of 10 to 30 percent. As to the suggestion that we use our discretion to avoid giving excessive awards, we note that the statute requires that we give an award of a minimum of 10 percent of the amount collected regardless of the overall size, and we do not have discretion to reduce that statutory minimum.

F. <u>Rule 21F-6 – Criteria for Determining Amount of Award.</u>

Assuming that all of the conditions for making an award to a whistleblower have been satisfied, Rule 21F-6 sets forth the criteria that the Commission will take into consideration in determining the percentage of the award between 10 and 30 percent.

a. Proposed Rule

As proposed, Rule 21F-6 provided that the Commission would consider four general criteria, when determining the percentage of a whistleblower award: (1)

significance of the information provided by a whistleblower to the success of the Commission action or related action; (2) degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the Commission action or related action; (3) programmatic interest of the Commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to successful enforcement actions; and (4) whether an award otherwise enhances the Commission's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers. The proposing release also stated that, when determining the percentage of a whistleblower award, the Commission would also be authorized to consider the following optional considerations: (1) character of the enforcement action; (2) dangers to investors or others presented by the underlying violations involved in the enforcement action; (3) timeliness, degree, reliability, and effectiveness of the whistleblower's assistance; (4) time and resources conserved as a result of the whistleblower's assistance; (5) whether the whistleblower encouraged or authorized others to assist the staff who might otherwise not have participated in the investigation or related action; (6) any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action; (7) degree to which the whistleblower took steps to prevent the violations from occurring or continuing; (8) efforts undertaken by the whistleblower to remediate the harm caused by the violations; (9) whether the information provided by the whistleblower related to only a portion of the successful claims brought in the Commission or related action; (10) culpability of the whistleblower; and (11) whether, and the extent to which, a whistleblower reported the possible violation through effective internal whistleblower, legal, or compliance procedures before reporting the violations to the Commission.

b. Comments Received

We received a wide range of comments on Proposed Rule 21F-6. The comments addressed the general methodology for making award determinations, and suggestions for additional criteria to be included in the rule. Commenters also responded to our specific questions about whether to include in the rule criteria concerning whether to increase awards to whistleblowers who reported into an internal compliance or reporting system and whether to reduce awards to culpable whistleblowers.

With respect to methodology, some commenters recommended that we adopt a more transparent methodology for making award determinations.[261] Others urged we adopt a methodology in which certain criteria would have the same impact on our award determinations in all cases, such as by giving the factor greater weight than other criteria,[262] or by using a factor to decrease a whistleblower's award[263] or to cap a whistleblower's award at 10 percent.[264] Several commenters suggested that some of the optional considerations for making awards outlined in the release should be required

[261] *See, e.g.*, letters from Harold Burke and Partrick Burns.

[262] *See* the letter from the NSCP.

[263] *See, e.g.*, letters from Valspar, Institute of Internal Auditors, and Washington Legal Foundation.

[264] *See, e.g.*, letters from Anixter Int., Business Roundtable, Taft, Financial Services Roundtable, Alcoa Group.

and placed into the rule text.[265] Other commenters recommended additional factors that should be considered by the Commission when making an award.[266]

Commenters expressed strong and divergent views on whether to include a factor related to a whistleblower's use of internal compliance and reporting systems. Many commenters suggested that the optional award consideration relating to whether a whistleblower reported a possible securities violation through effective internal whistleblower, legal, or compliance procedures before reporting it to the Commission should be listed as a required factor in the rule text.[267] Others, however, argued that the optional award consideration should be eliminated because it is inconsistent with the statute's purpose, vague, and impractical because it would require the Commission to independently determine the effectiveness of internal compliance programs and to make subjective conclusions about the whistleblower's specific circumstances and mindset.[268]

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[265] *See, e.g.*, letters from the Association of Corporate Counsel, Foster Wheeler, Anixter Int., Business Roundtable, Financial Services Roundtable, Society of Corporate Secretaries, Wells Fargo, Ethics & Compliance Officer Association, Alcoa Group, Deloitte, CCMC, Apache Group.

[266] *See, e.g.*, letters from Harold Burke (whether the submission exposed a nationwide practice; whether the whistleblower, or whistleblower's counsel, did not provide or offer to provide any help after submitting the tip, or hampered the government's efforts in developing its case; and whether the whistleblower substantially delayed reporting the fraud); John Wahh (whether the whistleblower benefitted from the securities violation); Chris Barnard (the role and culpability of the whistleblower in the reported securities violations); Auditing Standards Committee (the relative amount of the award, rather than the relative percentage amount); Georg Merkl (the economic risk the whistleblower took to come forward and report the securities violations); and DC Bar (new more detailed criteria for encouraging use of existing compliance programs).

[267] *See, e.g.*, letters from the Association of Corporate Counsel, Foster Wheeler, Anixter Int., Business Roundtable, Financial Services Roundtable, Society of Corporate Secretaries, Wells Fargo, Ethics & Compliance Officer Association, Alcoa Group, Deloitte, and CCMC.

[268] *See, e.g.*, letters from the NCCMP, Georg Merkl, Daniel J. Hurson, and Auditing Standards Committee.

In response to our question regarding whether the Commission should consider a whistleblower's role and culpability in the unlawful conduct to exclude the whistleblower from eligibility or as a criteria that would reduce the award amount, comments were also sharply divided.[269] Many commenters recommended that the Commission should reduce a culpable whistleblower's award because the failure to do so would create incentives for individuals to engage in wrongdoing or to conceal wrongdoing.[270] Other commenters suggested that the Commission should place this optional consideration into the rule text so that it would be required to be considered in every case.[271] Many other commenters opposed rules that would exclude culpable whistleblowers from eligibility for awards or would reduce the amount of their awards beyond what is already contained in the statute.[272] These commenters contended that, without sufficient financial incentives, insiders with the most knowledge and evidence about wrongdoing will not come forward, resulting in securities laws violations going undetected (or at least experiencing a further delay before they are detected).

c. Final Rule

Although we continue to believe the four criteria set forth in Proposed Rule 21F-6 — three of which derive from the statute —are important, we have significantly revised and restructured the final rule in response to comments. The changes are designed to

[269] *See, e.g.*, letters from the Auditing Standards, Apache Group, Georg Merkl, NWC, Connolly & Finkel, Target, SIFMA, Business Roundtable, Washington Legal Foundation, Morgan Lewis, Financial Services Roundtable, Society of Corporate Secretaries, Wells Fargo, TRACE International, Inc, Alcoa Group, Oppenheimer Funds, Association of Corporate Counsel, and CCMC.

[270] *See, e.g.*, letters from Connolly & Finkel, Target, SIFMA, Business Roundtable, Washington Legal Foundation, Morgan Lewis, Financial Services Roundtable, Society of Corporate Secretaries, Wells Fargo, Trace, Alcoa Group, Oppenheimer Funds, Association of Corporate Counsel, and CCMC.

[271] *See, e.g.*, letters from Apache Group.

[272] *See, e.g.*, Auditing Standards, Georg Merkl, and NWC.

describe more specifically the factors relevant to the Commission's determinations, and thus make award determinations more transparent, predictable, and fair. Similar to the approach used by the Department of Justice and Internal Revenue Service,[273] we adopt a methodology for determining awards where some factors suggest an increase and others a decrease in award percentage. This analytical framework incorporates into the final rule text the four required criteria from the proposed rule and the eleven optional considerations from the proposing release.

Under the final rule, when determining the percentage of a whistleblower award, the following required criteria may increase a whistleblower's award percentage: (1) significance of the information provided by the whistleblower (the first required criteria in the proposed rule and the statute); (2) assistance provided by the whistleblower (the second required criteria in the proposed rule and the statute); (3) law enforcement interest in making a whistleblower award (the third and fourth required criteria in the proposed rule and the third required criteria in the statute); and (4) participation by the whistleblower in internal compliance systems. In contrast, the following required criteria may decrease a whistleblower's award percentage: (1) culpability of the whistleblower; (2) unreasonable reporting delay by the whistleblower; and (3) interference with internal compliance and reporting systems by the whistleblower. Under many of the required criteria, we have set forth in the final rule related optional considerations that may be taken into account when considering the criteria. These potentially relevant factors are designed to provide greater detail regarding how award determinations will be made and to address commenters' other concerns and recommendations.

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[273] *E.g.*, Internal Revenue Manual § 25.2.2.9.2.

Although we have considered the views of commenters who recommended that the presence or absence of certain criteria should have a distinct and consistent impact on our award determinations, the final rule does not establish such a methodology that would permit a mathematical calculation of the appropriate award percentage. Since every enforcement matter is unique, the analytical framework adopted by the Commission in the final rule provides general principles without mandating a particular result. Accordingly, no attempt has been made to list the factors in order of importance, weigh the relative importance of each factor, or suggest how much any factor should increase or decrease the award percentage. Depending upon the facts and circumstances of each case, some factors may not be applicable or may deserve greater weight than others. Furthermore, the absence of any one of the positive factors does not mean that the award percentage will be lower than 30 percent, nor does the absence of negative factors mean the award percentage will be higher than 10 percent. Thus, a whistleblower would not be penalized for not satisfying any one of the positive factors. For example, a whistleblower who provides the Commission with significant information about a possible securities violation and provides substantial assistance in the Commission action or related action could receive the maximum award regardless of whether the whistleblower satisfied other factors such as participating in internal compliance programs. In the end, we anticipate that the determination of the appropriate percentage of a whistleblower award will involve a highly individualized review of the facts and circumstances surrounding each award using the analytical framework set forth in the final rule.

In response to concerns expressed by commenters that the proposed rules could incentivize whistleblowers to bypass corporate compliance programs, delay reporting violations, or otherwise interfere with internal compliance systems in order to enhance their future award, we have taken several steps to address this in the final rule. First, to reflect the important investor protection role that corporate compliance programs can serve and increase the incentive for whistleblowers to participate in these programs, the final rule includes a positive factor that requires the Commission to assess whether the whistleblower participated in his or her company's internal compliance and reporting systems.[274] Second, to minimize ongoing investor harm, maximize the deterrent impact of our enforcement cases, and to discourage delayed reporting by whistleblowers, the final rule includes a negative factor that requires the Commission to assess whether the whistleblower substantially and unreasonably delayed reporting the securities violations. Lastly, to penalize whistleblowers who attempt to undermine their employer's internal compliance or reporting systems, the final rule includes a negative factor that requires the Commission to assess whether there is evidence provided to the Commission that the whistleblower intentionally interfered with his or her company's internal compliance systems. Together, these provisions are designed to give whistleblowers appropriate

[274] Unlike the optional consideration in the release to the proposed rule, the final rule does not require the Commission to evaluate whether the internal compliance and reporting systems of an entity are "effective." We believe that defining what constitutes "effective" internal compliance procedures for a wide range of entities is beyond the scope of these rules and determining whether such procedures existed at a specific entity would impose an unnecessary administrative burden on the staff. Accordingly, the final rule relies on whistleblowers to determine whether reporting potential securities violations internally would be appropriate or desirable at their entity, without requiring us to independently and subsequently assess the effectiveness of their entity's internal compliance procedures. However, in determining whether to give a company the opportunity to investigate and report back, the Commission may consider information we have about the company's internal compliance programs." *See supra* at n. 199.

incentives to report securities violations voluntarily to their corporate compliance programs and not to impair the effectiveness of these important programs.

As discussed in greater detail below in the discussion of Rule 21F-16, we do not believe that a *per se* exclusion for culpable whistleblowers is consistent with Section 21F of the Exchange Act. By allowing certain less-culpable whistleblowers to receive awards consistent with the limitations set forth in the final rules, we have provided incentives for persons involved in wrongdoing to come forward and disclose illegal conduct involving others while limiting awards to those whistleblowers. However, after considering the public policy concerns expressed by commenters, we have included in the final rule a negative factor that requires the Commission to assess the culpability or involvement of the whistleblower in matters associated with the Commission's action or related actions.

G. Rule 21F-7 - Confidentiality of Submissions

a. Proposed Rule

Proposed Rule 21F-7 reflected the confidentiality requirements set forth in Section 21F(h)(2) of the Exchange Act[275] with respect to information that could reasonably be expected to reveal the identity of a whistleblower. As a general matter, it is the Commission's policy and practice to treat all information obtained during its investigations as confidential and nonpublic. Disclosures of enforcement-related information to any person outside the Commission may only be made as authorized by the Commission and in accordance with applicable laws and regulations. Consistent with Section 21F(h)(2), we proposed Rule 21F-7 to explain that the Commission will not

[275] 15 U.S.C. 78u-6(h)(2).

reveal the identity of a whistleblower or disclose other information that could reasonably be expected to reveal the identity of a whistleblower, except under circumstances described in the statute and the rule.[276]

Paragraph (a)(1) of the proposed rule authorized disclosure of information that could reasonably be expected to reveal the identity of a whistleblower when disclosure is required to a defendant or respondent in a federal court or administrative action that the Commission files or in another public action or proceeding filed by an authority to which the Commission may provide the information. For example, in a related action brought as a criminal prosecution by the Department of Justice, disclosure of a whistleblower's identity may be required, in light of the requirement of the Sixth Amendment of the Constitution that a criminal defendant have the right to be confronted with witnesses against him.[277] Proposed paragraph (a)(2) authorized disclosure to the Department of Justice, an appropriate regulatory agency, a self regulatory organization, a state attorney general in connection with a criminal investigation, any appropriate state regulatory authority, the Public Company Accounting Oversight Board, or foreign securities and law enforcement authorities when it is necessary to achieve the purposes of the Exchange Act and to protect investors. With the exception of foreign securities and law enforcement authorities, each of these entities is subject to the confidentiality requirements set forth in Section 21F(h) of the Exchange Act. Since foreign securities and law enforcement authorities are not bound by these confidentiality requirements, the rule stated that the Commission may determine what assurances of confidentiality

[276] Under Section 21F(h)(2), whistleblower-identifying information is also expressly exempted from the provisions of the Freedom of Information Act, 5 U.S.C. 552.

[277] *See* U.S. Const. Amend. VI.

are appropriate prior to disclosing such information. Paragraph (a)(3) authorized disclosure in accordance with the Privacy Act of 1974.

Because many whistleblowers may wish to provide information anonymously, paragraph (b) of the proposed rule stated that anonymous submissions will be permitted with certain specified conditions. Proposed paragraph (b)(1) required that anonymous whistleblowers be represented by an attorney and that the attorney's contact information be provided to the Commission at the time of the whistleblower's initial submission. The purpose of this requirement was to prevent fraudulent submissions and to facilitate communication and assistance between the whistleblower and the staff. Any whistleblower may be represented by counsel - - whether submitting information anonymously or not.[278] Proposed paragraph (b)(2) required that anonymous whistleblowers and their counsel follow the required procedures outlined in Proposed Rule 21F-9. Paragraph (b)(3) required that anonymous whistleblowers disclose their identity, pursuant to the procedures outlined in Proposed Rule 21F-10, before the Commission will pay any award, as is required by the statute. In the proposing release, we also solicited comments on whether we should include limits on the fees attorneys may collect from whistleblowers under our program.

b. Comments Received

We received few comments related to the confidentiality provisions. One commenter expressed concern about the Commission's exercise of its authority to share the identity of a whistleblower with a foreign law enforcement or regulatory

[278] *See* Section 21F(d)(1), 15 U.S.C. 78u-6(d)(1). Under the statute, however, an anonymous whistleblower seeking an award is required to be represented by counsel. Section 21F(d)(2), 15 U.S.C. 78u-6(d)(2).

authority because the whistleblower will have no assurance against the possibility of adverse consequences other than "trust[ing] the [foreign] country's regulators."[279] Another commenter stated that the Commission has no authority to compel an attorney to reveal the identity of an anonymous whistleblower, and that, in cases where we know the whistleblower's identity, our rules should require that we notify the whistleblower, and provide the whistleblower an opportunity to seek a protective order, any time the whistleblower's identity may be revealed.[280] A third commenter noted that allowing a whistleblower to remain anonymous could encourage false or overstated claims.[281]

Because an anonymous whistleblower must retain an attorney and because an attorney representing a whistleblower will be deemed to be practicing before the Commission, we requested comments on whether the Commission should adopt rules governing conduct by attorneys representing whistleblowers and in particular rules regarding attorneys' fees in the representation of whistleblowers. The majority of commenters opposed the adoption of a rule regarding fees.[282] The rationales offered in support of this objection included that such a rule would make it nearly impossible for corporate whistleblowers to obtain attorneys to represent them in Dodd-Frank cases; excessive attorneys' fees already are governed by state bar rules; and such a rule would interfere with the contractual relationship between a whistleblower and his or her attorney.

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[279] *See* letter from Eric Dixon, LLC; *see also* pre-release letter from Ruby Monroe (expressing concern for confidentiality of whistleblowers from foreign jurisdictions).

[280] Letter from NWC.

[281] Letter from Bruce McPheeters.

[282] *See, e.g.*, NWC; Grohovsky Group; American Association for Justice; Continewity; Stuart D. Meissner, LLC.

In contrast, several commenters recommended that the Commission adopt by rule or otherwise publicly state that attorneys representing a whistleblower will not be entitled to receive a contingency fee based on any amount ultimately rewarded to the whistleblower.[283] The rationales offered for this recommendation included that a whistleblower's counsel is not likely to participate materially in the investigation of a matter filed through the whistleblower program;[284] public companies may be inundated with frivolous claims or claims based on incomplete information brought by attorneys who represent multiple complainants, hoping that one of them will be successful in an award from the Commission;[285] and a whistleblower in a difficult situation may have limited ability to negotiate appropriate fees for representation.[286]

Other commenters addressed the question of whether the Commission should adopt rules regarding attorney conduct generally. Two commenters suggested that the Commission adopt attorney conduct standards for attorneys representing whistleblowers since a myriad of law firms will be advertising and soliciting work on whistleblowing. One suggested adopting, for the representation of whistleblowers, some form of 17 CFR § 205.1 et. seq., which details the requirements of Section 307 of the Sarbanes Oxley Act addressing standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers.[287] The other noted that the Commission should clarify or confirm that an attorney representing

[283] Letters from Baker Donelson; Washington Legal Foundation; Institute of Internal Auditors.

[284] Letter from Baker Donelson.

[285] *Id.*

[286] Letter from Institute of Internal Auditors.

[287] Letter from Americans for Limited Government.

a whistleblower under Section 21F(d)(1) or (2) will be deemed to be "appearing or practicing before the Commission" and thereby be bound by Section 4C of the Exchange Act and Section 102 of the Rules of Practice of the Commission.[288]

c. Final Rule

We are adopting Rule 21F-7 largely as proposed. The rule tracks the provisions of the statute and identifies those instances where the Commission, in furtherance of its regulatory responsibilities, may provide information to certain delineated recipients.

We made two changes. First, we changed the term "appropriate regulatory agency" to "appropriate regulatory authority." As discussed above, our use of this newly-defined term, which excludes the Commission, better reflects the facts that we share information with other agencies, and, that under our rules, related actions similarly are actions brought by other agencies that are based upon a whistleblower's information.[289]

Second, where we share information that could reasonably be expected to reveal the identity of a whistleblower with foreign securities or law enforcement authorities, we proposed that we "may determine what assurances of confidentiality" we deem necessary. We have changed that language to state that we "will" make such a determination, thereby making clear, consistent with Section 21F, that we will obtain appropriate assurances of confidentiality before sharing such information with foreign authorities. We plan to work closely with whistleblowers or their attorney in an effort to take appropriate steps to maintain their confidentiality, consistent with the requirements

[288] Letter from Baker Donelson, PC.

[289] *See* Rule 21F-4(g).

of Section 21F(h)(2).[290] At the same time, however, Congress expressly authorized us to disclose whistleblower-identifying information subject to the limitations and conditions set forth in Section 21F(h)(2). Accordingly, we do not believe it would be consistent with either Congress's intent or with the proper exercise of our enforcement responsibilities to require by rule that our staff notify a whistleblower before any authorized disclosure, and provide the whistleblower with an opportunity to seek a protective order.

In addition, as we noted in our proposing release, pursuant to Rule 102(e) of the Commission's Rules of Practice,[291] the Commission may deny the privilege of practicing before the Commission to any person who, after notice and opportunity for hearing, is found not to possess the requisite qualifications to represent others, to be lacking in character or integrity, to have engaged in unethical or improper professional conduct, or to have willfully violated or willfully aided and abetted the violation of any provision of the federal securities laws or rules. Practice before the Commission is defined to include transacting any business with the Commission.[292] Representation of whistleblowers will constitute practice before the Commission, and thus, misconduct by an attorney representing a whistleblower can result in the attorney being subject to disciplinary sanctions under any of the conditions set forth in Rule 102(e).

We have also decided not to include a rule regarding attorneys' fees in our Final Rule. While there are reasonable arguments on both sides, we think the better approach is to leave issues of attorneys' fees to state bar authorities and to contractual

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[290] For example, we are adding a question to our whistleblower submission form that asks whistleblowers to tell us if they are giving us any particular documents or other information in their submission that they believe could reasonably be expected to reveal their identity.

[291] 17 CFR § 201.102(e).

[292] 17 CFR § 102(f).

arrangements between prospective whistleblowers and their attorneys. We believe that both state bar authorities and individual whistleblowers are better equipped than the Commission to make determinations regarding the appropriate amount of attorneys' fees.

H. Rule 21F-8 – Eligibility

a. Proposed Rule

Paragraph (a) of Proposed Rule 21F-8 provided that whistleblowers must provide information in the form and manner required by these rules in order to be eligible for a whistleblower award.[293] The proposed rule also stated that the Commission, in its sole discretion, may waive any of these procedural requirements based upon a showing of extraordinary circumstances.

The specific procedures required for submitting original information and making a claim for a whistleblower award were described in Proposed Rules 21F-9 through 21F-11. Proposed Rule 21F-8(b) contained several additional procedural requirements designed to assist the Commission in evaluating and using the information provided. These included that the whistleblower, upon request, agree to provide explanations and other assistance including, but not limited to, providing all additional information in the whistleblower's possession that is related to the subject matter of his submission.

Paragraph (b) of the proposed rule also required whistleblowers, if requested by the staff, to provide testimony or other acceptable evidence relating to whether they are eligible for or otherwise satisfy any of the conditions for an award. Proposed paragraph

[293] *See* Section 21F(c)(2)(D), which prohibits the Commission from paying an award to any whistleblower "who fails to submit information to the Commission in such form as the Commission may, by rule, require. 15 U.S.C. 78u-6(c)(2)(D)."

(b) also authorized the staff to require that a whistleblower enter into a confidentiality agreement in a form acceptable to the Office of the Whistleblower, including a provision that a violation may result in the whistleblower being ineligible for an award.[294]

Paragraph (c) of Proposed Rule 21F-8 recited the categories of individuals ineligible for an award, many of which are set forth in Section 21F(c)(2). These include persons who are, or were at the time they acquired the original information, a member, officer, or employee of the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization; anyone who is convicted of a criminal violation that is related to the Commission action or to a related action for which the person otherwise could receive an award; any person who obtained the information provided to the Commission through an audit of a company's financial statements, and making a whistleblower submission would be contrary to the requirements of Section 10A of the Exchange Act (15 U.S.C. 78j-1); and any person who in his whistleblower submission, his other dealings with the Commission, or his dealings with another authority in connection with a related action, knowingly and willfully makes any false, fictitious, or fraudulent statement or representation, or uses any false writing or document, knowing that it contains any false, fictitious, or fraudulent statement or entry. Paragraph (c)(2) of Proposed Rule 21F-8 also made foreign officials ineligible to receive a whistleblower award. In order to prevent evasion of these exclusions, paragraph (c)(5) of the proposed rule also provided that persons who acquire information from ineligible individuals are ineligible for an award. In addition, paragraph (c)(6) made any person

[294] Section 21F(e) of the Exchange Act authorizes the Commission to require that a whistleblower enter into a contract. 15 U.S.C. 78u-6(e).

ineligible who is the spouse, parent, child, or sibling of a member or employee of the Commission, or who resides in the same household as a member or employee of the Commission, in order to prevent the appearance of improper conduct by Commission employees.

b. Comments Received

We received several comments on these sections. One commenter opposed the provision under which the Commission could require whistleblowers to enter into confidentiality agreements, stating that the statute does not authorize this requirement and it may violate a whistleblower's free speech rights and interfere with a whistleblower's ability to sue Commission staff.[295] Other commenters stated that the Commission should not add to the list of ineligible persons designated by Congress.[296] One commenter suggested that the provision making ineligible any whistleblower who knowingly uses a false writing or document in a submission should be redrafted to clarify that the exclusion only applies if a whistleblower does so with intent to deceive the Commission. The commenter stated that this change would permit a whistleblower to submit a false document created by someone else as evidence of that other person's or entity's wrongdoing.[297]

Another commenter noted that significant information could come from whistleblowers who are employees of state-owned foreign companies, and that our rule

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[295] Letter from NWC.

[296] Letters from Stuart D. Meissner, LLC, Chris Barnard.

[297] Letter from Grohovsky Group.

would treat those employees as foreign officials and would thus deem them ineligible for an award.[298]

Although proposed Rule 21F-8(c)(5) was intended to prevent evasion of our rules by making ineligible any whistleblower who acquires information from other ineligible persons, some comments suggested that, as proposed, the rule was at once too broad and too narrow in certain respects. One commenter noted that a similar provision in proposed Rule 21F-4(b)(4) created, in effect, a "hearsay exception" that would exclude from eligibility any whistleblower who overheard an excluded individual talking about a fraud in which the other person was a participant.[299] Another commenter pointed out that a culpable whistleblower could evade the limitations of proposed Rule 21F-15 simply by providing information about violations to a third party.[300]

Finally, one commenter urged that we deem ineligible any whistleblower who refused to cooperate with a company's internal investigation, or who provided inaccurate or incomplete information or otherwise hindered such an investigation.[301]

c. Final Rule

After considering these comments, we are adopting the proposed rule with certain modifications. The eligibility requirements reflect the express requirements and limitations set forth in Section 21F, and are otherwise a reasonable exercise of our authority to adopt rules that are necessary or appropriate to implement the provisions of Section 21F.

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[298] Letter from NWC.

[299] *See* letter from NWC.

[300] *See* letter from ABA.

[301] Letter from SIFMA.

As adopted, Rule 21F-8(b)(4) provides that a whistleblower may be required to enter into a confidentiality agreement as to any non-public information that the Commission provides to the whistleblower. The addition of the reference to "non-public" information that "the Commission provides" clarifies that the rule does not limit the whistleblower's use of information that he or she already knows, or learns from other sources, and does not acquire through our investigation.

We have also changed proposed Rule 21F-8(c)(5) (now re-designated as Rule 21F-8(c)(6)) to provide that a person is ineligible if he or she acquires original information from either a person who is subject to the auditors exclusion found in paragraph (c)(4) (discussed below), unless the information is not excluded from that person's use, or the whistleblower is providing the Commission with information about possible violations involving that person, or from any person with intent to evade any provision of these rules. The first part of this provision tracks the language of Rule 21F-4(b)(4)(vi), and is simply intended to assure consistent treatment under Rule 21F-8 and Rule 21F-4(b)(4) of potential whistleblowers who obtain their information from independent public accountants involved in engagements required under the federal securities laws. The second part of this provision is designed to prevent persons who are prohibited or limited in making a claim under any provision of our rules (including culpable whistleblowers under Rule 21F-16) from evading our rules by colluding with a third party. This change also clarifies that the intent of the exclusion is to address efforts to evade our rules, and not persons who legitimately learn about violations being perpetrated by ineligible persons.

We have decided to maintain the exclusion for "foreign officials" as proposed. The exclusion for foreign officials would include employees of foreign instrumentalities, including state-owned entities. Our conclusion is informed by the Foreign Corrupt Practices Act,[302] which includes within its definition of "foreign officials" those who are employed by an instrumentality of a foreign government, which includes state-owned entities.[303] We believe that it is appropriate to treat the exclusion for foreign officials under the whistleblower program consistent with the definition of foreign official under the FCPA, because FCPA enforcement actions are the contexts in which the exclusion is most likely to apply. Inconsistent treatment could, we believe, risk unnecessary confusion as to when and under what circumstances someone is a foreign official for purposes of two closely related provisions of the securities laws.

In addition, whistleblower awards to employees of foreign state-owned entities have the potential to create some of the same negative repercussions discussed in the proposed rule, *i.e.*, the perception that the United States is interfering with foreign sovereignty, potentially undermining foreign government cooperation under existing treaties (including multilateral and bilateral mutual legal assistance treaties), the incentive for foreign officials to make reports to the United States rather than to local

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[302] Broadly, the anti-bribery provisions of the FCPA make it unlawful for issuers (and their officers, directors, employees, agents and stockholders), domestic concerns, and foreign persons and entities (acting within the U.S.), to make, offer or authorize the payment of bribes, directly or indirectly, to foreign officials, foreign parties, foreign party officials, and foreign candidates for public office for the purpose of obtaining or retaining business for or with, or directing business to, any person. *See* 15 U.S.C. §§ 78dd-1, et seq.

[303] A "foreign official" is defined in the FCPA as "any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization." *See* 15 U.S.C. §§ 78dd-2(h)(2)(A).

authorities, and concerns about protection of foreign officials who become whistleblowers.

We have also modified Rule 21F-8(c)(7) to clarify that the exclusion of a whistleblower for using any false writing or document that contains a false, fictitious, or fraudulent statement or entry will only apply when the whistleblower thereby intends to mislead or otherwise hinder the Commission or another authority in connection with a related action.[304]

We have determined not to adopt an eligibility exclusion based on a whistleblower's conduct with respect to an internal investigation. In some cases, a whistleblower may have a reasonable concern that causes him or her to report misconduct directly to the Commission. In other cases, this concern may be less justified. However, we believe that a categorical rule that excludes whistleblowers for failure to reasonably cooperate with internal investigations would create too much uncertainty, and too great a disincentive, for whistleblowers who are considering how to report misconduct. Thus, such a rule would undermine the effectiveness of the whistleblower program. In appropriate circumstances, however, we will consider the whistleblower's conduct in connection with an internal investigation in the determination of whether the whistleblower's conduct "led to" a successful enforcement action,[305] and/or in determining the amount of an award.

[304] *See* letter from Grohovsky Group.

[305] For example, if a whistleblower hindered an internal investigation, but the company nonetheless self-reported violations, we could consider the whistleblower's conduct in determining whether the whistleblower caused us to open an investigation into the matter.

Finally, Rule 21F-8(c)(4) reflects the exclusions set forth in Section 21F(c)(2)(C) for persons who obtain information through the performance of an audit of financial statements and for whom a whistleblower submission "would be contrary to the requirements of Section 10A" of the Exchange Act.

We are adopting Rule 21F-8(c)(4) as it was originally proposed without change, as it largely tracked the language of Section 21F(c)(2)(C). The statute prohibits an award "... to any whistleblower who gains the information through the performance of an audit of financial statements required under the securities laws and for whom such submission would be contrary to the requirements of section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1)."

Rule 21F-8(c)(4) accordingly only disqualifies those submissions that are contrary to Section 10A. The most obvious example is where the auditor did not file a "10A Report" with the SEC's Office of Chief Accountant, but instead submitted information about the company's illegal act to us to be considered for the award under the whistleblower program.

In adopting this rule we carefully considered the comments on Rule 21F-4(b)(4)(iii) because those issues are similar to ones implicated in determining eligibility. In connection with that proposal, some commenters advocated that individuals should not be allowed to make a submission alleging that the firm violated Section 10A, while others recommended allowing such a rule.[306] The rule we are adopting today allows an

[306] Letters from PwC, KPMG, Center for Audit Quality ("CAQ"), Deloitte, Ernst & Young ("EY"), TAF. *Compare*, CAQ ("The CAQ has concerns about the Proposed Rules to the extent that they permit whistleblower awards for information reported by an independent public accountant regarding his or her firm's performance of services related to an engagement required under the securities laws (i.e., whistleblower reporting by an accountant with respect to his or her own firm's performance of services"), *with* TAF ("...where that legal duty is not honored, and the audit film fails to comply with its obligations under Section 10A, a whistleblower's submission of the information to the SEC is consistent with both

accountant to make a submission alleging that his firm violated Section 10A (or other professional standards), because such a submission is not "contrary to the requirements of Section 10A." If such a submission is made, then, as is the case with Rule 21F-4(b)(4)(iii)(D), the whistleblower will also be able to obtain an award if the information leads to a successful action against the engagement client.

An allegation that a firm violated Section 10A is consistent with the statute especially when the allegation is that an audit firm failed to assess or investigate illegal acts or make a report to the Commission. Accordingly, a person can make a submission that alleges not only that the audit firm failed to make a report with the Commission under Section 10A(b)(3), but also that the firm failed to follow any other procedures set forth in Section 10A or professional standards.[307] By specifically allowing allegations of violations of the federal securities laws or professional standards the rule may help insure that wrongdoing by the firm (or its employees) is reported in a timely fashion. This is especially important because of the important gatekeeper role that auditors play in the securities markets.

Commission staff will carefully evaluate a submission alleging a Section 10A violation to determine whether it contains a specific and credible allegation of a violation of Section 10A.[308] A specific and credible allegation is one made in good faith and is

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Section 10A and the Commission's overall enforcement mission. In such circumstance, the policies underlying both Section 10A and Dodd Frank weigh in favor of rewarding the whistleblower who reports wrong doing when the audit firm has failed to.").

[307] Violations of law are not restricted to the audit or interim review work performed by an audit firm. For example, if an employee observes insider trading, auditor independence failures at a firm or other quality control failures that are not specific to any particular audit, then a submission containing those allegations is permitted.

[308] As with other submissions, the contents are sworn under penalty of perjury which provides additional safeguards against pretextual submissions.

not a pretext for circumventing the requirements of Section 10A. In assessing whether an allegation of a firm's Section 10A violation is specific and credible, the staff may consider the facts and circumstances surrounding the submission, including the level of detail, documentary support, descriptions of particularized conduct or omissions by identified persons, as well as the materiality or non-triviality of the alleged Section 10A violation. For example, the Commission may consider, among other things:

- whether the audit firm conducted an assessment of or investigation into the alleged illegal act by the issuer and the quality of that investigation;
- whether the audit firm followed the requirements of Section 10A and its response to the allegation of an illegal act;
- the position or title of the whistleblower and the role the person played in the firm's violations;
- the role of the whistleblower in the Section 10A investigation or assessment; and
- the timing of the submission.

We are also providing guidance about several important aspects of Rule 21F-8(c)(4). First, the information must be gained through the work done for an audit for an issuer.[309] Non-issuers, such as broker dealers or investment advisors,[310] are not covered by Section 10A and, subject to Rule 21F-(b)(4)(iii)(D), submissions relating to them are allowed.

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309 The text of Section 10A only refers to audits of financial statements of issuers and thus the requirements – including the reporting requirements – are imposed on audits for issuers. Issuer is a defined term under Section 10A.

310 In some instances, broker dealers or investment advisors may also be issuers as that term is defined in Section 10A.

Second, we interpret the phrase "through an audit of a company's financial statements" in Rule 21F-8(c)(4) as meaning information that is learned through an audit of a company's financial statements when it is linked to audit procedures or audit work. Accordingly, the phrase clearly and most directly applies to members of an audit engagement team. It applies to the engagement partner, quality review partner, and other people working directly on the engagement. It also applies to foreign affiliates or specialists who are used by the engagement team.[311]

Third, although both Dodd-Frank and Section 10A only refer to "audits of financial statements," we believe this includes quarterly reviews, which are frequently viewed as a step in the annual audit process and therefore may properly be considered as encompassed within Section 10A's scope. Accordingly, if an auditor discovers or detects an illegal act during either a quarterly review or annual audit, it is required to comply with Section 10A.[312] An audit firm's failure to follow the procedures or otherwise comply with Section 10A when confronted with an illegal act – regardless of whether the violation is detected during a year-end audit or an interim review -- is a violation of law

[311] Information is also learned through an audit of a company's financial statements when other professionals learn of a company's illegal act as a result of communications with the audit engagement team as part of the audit. For example, if the national office of an audit firm were consulted about a possible illegal act, including accounting irregularities, then the national office personnel consulted on the matter would not be eligible for a whistleblower award based on that information. Similarly, if a tax professional at an audit firm were consulted to assist in auditing the tax footnote for an issuer and learned of an illegal act, then that person would not be eligible for a whistleblower award. In other words, where professional staff is performing procedures for an audit or have been contacted by someone performing procedures for an audit, the information was gained through an audit. However, if one of these other professionals who are performing work for an audit also learns of a violation by the audit firm or its associated persons, then he may be eligible for an award with respect to a violation by the firm.

[312] Under Section 10A auditors must notify senior management of the issuer and the audit committee of illegal acts even if they are immaterial to the financial statements. *See* Section 10A(b)(1).

and an individual would be able to make a submission alleging that his audit firm violated the law or professional standards.

Information gained through the audit of financial statements extends beyond illegal conduct with respect to the financial statements themselves. Section 10A broadly defines "illegal act" as any "act or omission that violates any law, or any rule or regulation having the force of law." Further, the statutory disqualification was not limited to information gained only about financial statements; rather, it disqualified a submission where the person "gains the information through the performance of an audit of financial statements required under the securities laws."

In response to a footnote in the proposing release, certain commenters from the audit profession advocated expanding the scope of the exclusion to disqualify virtually all employees of accounting firms, regardless of whether those employees are performing audit services or are performing services for public companies.[313] The footnote stated: "The Commission anticipates this exclusion would also apply to information gained through another engagement by the independent public accountant for the same client, given that the independent public accountant would generally already have an obligation to consider the information gained in the separate engagement in connection with the Commission-required engagement."

As noted above, we are clarifying the application of information obtained "through an audit of a company's financial statements" with respect to firm personnel outside of

[313] *E.g.*, PwC ("The exclusion should extend to all reports by employees of accounting firms with respect to information obtained through performing services of any nature for an audit client. The exclusion should not be limited to information obtained through the engagement required by the securities laws itself."); Deloitte ("Deloitte urges the Commission to provide expressly in the final rules that whistleblowers whose information was obtained through any services to public company audit clients provided by an accounting firm are excluded from eligibility to receive a whistleblower award.")

the audit engagement team itself. We decline to codify a *per se* exclusion for all employees or all engagements, especially engagements involving non-issuer clients. Persons working on other engagements, to the extent that they are not covered by Section 10A or are not required under the federal securities laws, will not be deemed ineligible simply because the engagement is with an audit client of the firm.

Several commenters recommended that whistleblowers should have to use internal reporting processes by either reporting up the chain at the audit firm or reporting to the audit client.[314] We are declining to adopt a rule that would require all employees of accounting firms use the internal processes whether at the audit firm or at the audit client. This approach is consistent with the final rule regarding internal compliance persons, and we address certain of these commenters' concerns through our adoption of Rule 21F-4(b)(4)(D).

Finally, a submission is not contrary to 10A – even where the 21F-8(c)(4) exception would otherwise apply – where the whistleblower has a reasonable basis to believe either of the following: (i) the disclosure of the information to the Commission is necessary to prevent the relevant entity from committing a material violation of the securities laws that is likely to cause substantial injury to the financial interest or property of the entity or investors; or (ii) the relevant entity is engaging in conduct that

[314] *E.g.*, letter from Deloitte (""Any final rule should require, as a condition of eligibility to receive a monetary award that whistleblowers report their concerns fully and in good faith through company sponsored whistleblower systems before reporting externally. At a minimum, the final rules should require the concurrent submission of internal and external reports. In the alternative, any final rule should expressly state that good-faith internal reporting prior to making any external report will be considered a strongly positive factor in determining the amount of a whistleblower award, and that a whistleblower's failure to use internal whistleblower systems prior to reporting to the SEC will be considered a strongly negative factor.")

will impede an investigation of misconduct even if the submission does not contain an allegation of audit firm wrongdoing.[315]

I. Rule 21F-9 - Procedures for Submitting Original Information

Proposed Rule 21F-9 set forth a two-step process for the submission of original information. The first step required the submission of information either on a standard form or through the Commission's online database for receiving tips, complaints and referrals. The second step required the whistleblower to complete a separate declaration form, signed under penalty of perjury, in which the whistleblower would be required to make certain representations concerning the veracity of the information provided and the whistleblower's eligibility for a potential award. In response to comments, we are adopting a more streamlined process that requires submitting only one form signed under penalty of perjury.

a. Proposed Rule

Paragraph (a) of Proposed Rule 21F-9 required the submission of information in one of two ways. A whistleblower could submit the information electronically through the Commission's Electronic Data Collection System available on the Commission's website or by completing and submitting proposed Form TCR - *Tip, Complaint or Referral*.[316] Proposed Form TCR, and the instructions thereto, were designed to

[315] We have not adopted the 120-day exclusion set forth in Rule 4(b)(4)(vi)(C) because we believe it is unnecessary here. Section 10A provides that, if an issuer fails to report to the Commission any securities law violations discovered in the course of the Section 10A audit, the independent public accounting firm must do so. The firm's failure to promptly report the information to the Commission constitutes a violation of Section 10A. A whistleblower may *at any point* thereafter report this Section 10A violation to the Commission, and thus become eligible for an award based on a covered action against the public accountant or the issuer.

[316] The Electronic Data Collection System is the Commission's interactive, web-based database for submission of tips, complaints and referrals. Both the online database and proposed Form TCR are designed to elicit substantially similar information concerning the individual submitting the information and

capture basic identifying information about a complainant and to elicit sufficient information to determine whether the conduct alleged suggests a violation of the federal securities laws.[317]

In addition to submitting information in the form and manner required by paragraph (a), we proposed in paragraph (b) of Proposed Rule 21F-9 that whistleblowers who wish to be considered for an award in connection with the information they provided to the Commission must also complete and provide the Commission with a separate form -- proposed Form WB-DEC, *Declaration Concerning Original Information Provided Pursuant to §21F of the Securities Exchange Act of 1934.* Proposed Form WB-DEC required a whistleblower to answer certain threshold questions concerning the whistleblower's eligibility to receive an award. The form also contained a statement from the whistleblower acknowledging that the information contained in the Form WB-DEC, as well as all information contained in the whistleblower's submission, was true, correct and complete to the best of the whistleblower's knowledge, information and belief. Moreover, the statement acknowledged the whistleblower's understanding that the whistleblower may be subject

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the violation alleged. On November 9, 2010, we separately submitted a request to the Office of Management and Budget for Paperwork Reduction Act approval of the Electronic Data Collection System. Accordingly, for purposes of these rules, we are only discussing proposed Form TCR.

317 Items A1 through A4 of proposed Form TCR requested the whistleblower's personal information, including name, contact information and occupation. In instances where a whistleblower submitted information anonymously, the identifying information for the whistleblower would not be required, but proposed Items B1 through B4 of the form required the name and contact information of the whistleblower's attorney. This information could also be included in the case of whistleblowers whose identities are known and who are represented by counsel in the matter. Proposed Items C1 through C4 requested basic identifying information for the individual(s) or entit(ies) to which the complaint relates. Proposed Items D1 through D9 were designed to elicit details concerning the alleged securities violation. The questions posed on proposed Form TCR were designed to elicit the minimum information required for the Commission to make a preliminary assessment concerning the likelihood that the alleged conduct suggested a violation of the securities laws. Moreover, the proposed instructions to Form TCR were designed to assist the whistleblower and facilitate the completion of the form.

to prosecution and be ineligible for an award if, in the whistleblower's submission of information, other dealings with the Commission, or dealings with another authority in connection with a related action, the whistleblower knowingly and willfully made any false, fictitious, or fraudulent statements or representations, or used any false writing or document knowing that the writing or document contained any false, fictitious, or fraudulent statement or entry.

In instances where information is provided by an anonymous whistleblower, paragraph (c) of Proposed Rule 21F-9 required the attorney representing the whistleblower to provide the Commission with a separate Form WB-DEC certifying that the attorney has verified the identity of the whistleblower, and will retain the whistleblower's original, signed Form WB-DEC in the attorney's files. In the proposing release, we explained that the proposed certification from counsel was an important element of the whistleblower program to help ensure that the Commission is working with whistleblowers whose identities have been verified by their counsel. Additionally, the proposed certification process provided a mechanism for anonymous whistleblowers to be advised by their counsel regarding their preliminary eligibility for an award.[318]

[318] Items A1 through A3 of proposed Form WB-DEC requested the whistleblower's name and contact information. In the case of submissions by an anonymous whistleblower, the form required the name and contact information of the whistleblower's attorney instead of the whistleblower's identifying information in proposed Items B1 through B4. This section could also be completed in cases where a whistleblower's identity is known but the whistleblower is represented by an attorney in the matter. Proposed Items C1 through C3 requested information concerning the information submitted by the whistleblower to the SEC. Item C1 required the whistleblower to indicate the manner in which the information was submitted to the Commission. Proposed Item C2 asked for the TCR number assigned to the whistleblower's submission. Proposed Items C3 asked a whistleblower to identify any communications the whistleblower or his counsel may have had with the Commission concerning the matter since submitting the information. Proposed Item C4 asked whether the whistleblower has provided the same information being provided to the Commission to any other agency or organization and, if so, requested details concerning the submission, including the name and contact information for the point of contact at the agency or organization, if known. Proposed Items D1 through D9 required the whistleblower to make certain representations concerning the whistleblower's eligibility for an award. Finally, the form required the sworn declarations from the whistleblower and the whistleblower's counsel discussed above.

Finally, Proposed Rule 21F-9(d)(1) stated how whistleblowers who provided original information to the Commission in writing after the enactment of Dodd-Frank but before the adoption of final rules could perfect their status as whistleblowers under the Commission's award program. This provision required a whistleblower who provided original information to the Commission in a format or manner other than that required by paragraph (a) of Proposed Rule 21F-9 to either submit the information electronically through the Commission's Electronic Data Collection System or to submit a completed Form TCR within one hundred twenty (120) days of the effective date of the proposed rules, and to otherwise follow the procedures set forth in paragraph (b) of Proposed Rule 21F-9. If the whistleblower provided the original information to the Commission in the format or manner required by paragraph (a) of Proposed Rule 21F-9, paragraph (d)(2) would require the whistleblower to submit Form WB-DEC within one hundred twenty (120) days of the effective date of the proposed rules in the manner set forth in paragraph (b) of Proposed Rule 21F-9.

b. Comments Received

Commenters generally were of the view that our proposed procedures for submitting information should be streamlined.[319] Two commenters recommended that we adopt a process similar to that of the Internal Revenue Service, which requires the submission of only one form.[320] One commenter recommended eliminating the forms

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[319] *See, e.g.,* letters from NWC; Jane Liu; Patrick Burns; Alexander Hoover; NCCMP; DC Bar; Georg Merkl; Michael Lawrence.

[320] Letter from NCCMP; DC Bar. Two commenters also suggested that we adopt the IRS's certification language in IRS Form 211. *See* NCCMP; NWC.

altogether and requiring only a written submission.[321] A few commenters urged us to retain the flexibility to exercise our discretion to waive technical requirements as appropriate in particular circumstances, so as not to disqualify otherwise meritorious whistleblower tips on technical grounds.[322]

Several commenters recommended that we require proposed Form TCR to be signed under penalty of perjury, similar to the requirement for proposed Form WB-DEC.[323] These commenters expressed the view that the lapse of time between the filing of proposed Form TCR and the sworn Form WB-DEC could cause significant resources to be expended by a company in cases where a TCR containing a false or spurious claim is immediately investigated by the SEC.[324] One commenter recommended that, to protect against submissions that are not necessarily made in bad faith but nevertheless lack merit, the rules should require all submissions for which a whistleblower seeks an award to be certified by third-party professionals (such as attorneys, accountants and individuals with experience in compliance, ombuds and human resources functions) who would attest to their good faith, foundation, accuracy and relevance.[325]

A few commenters recommended modifications to the attorney certification requirement of Proposed Rule 21F-9(c) relating to submissions by anonymous whistleblowers. Two commenters suggested that, to ensure that whistleblowers who engage legal counsel do not submit claims based on mere speculation or hunches,

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321 Letter from NWC.

322 *See, e.g.* letters from DC Bar; NWC.

323 Letters from ABA; Goodwin Proctor.

324 *Id.*

325 Letter from Taft, Stettinius & Hollister, LLP.

attorneys handling anonymous claims should be required to review the client's information and certify that the client can show "particularized facts suggesting a reasonable probability" that a securities violation has actually occurred or is occurring.[326] By contrast, one commenter opposed the attorney certification requirement on grounds that it inappropriately shifts to attorneys responsibility for a client's fraudulent submission, the nature of which the attorney may be unaware.[327]

We received two comments relating to the proposed process for perfecting whistleblower status under paragraph (d) of Proposed Rule 21F-9. One commenter urged us to eliminate the 120-day deadline for perfecting whistleblower status.[328] Another took issue with the requirement that original information submitted after the date of enactment of the Dodd-Frank Act but before adoption of the final rules must be in writing in order to retain the status of original information.[329]

In the proposing release, we solicited comment on whether it would be appropriate to eliminate the fax and mail options and require that all submissions be made electronically. Some commenters expressed the view that eliminating fax and mail submission could discourage some whistleblowers, such as those with concerns about security and privacy[330] and persons who may be less familiar and comfortable

326 Letters from ABA; Goodwin Procter.

327 *See* letter from Eric Dixon, LLP.

328 Letter from Georg Merkl.

329 Letter from Storch Amini. We note that this requirement emanates from the statute and not from our proposed rules.

330 Letter from Auditing Standards Committee; Institute of Independent Auditors.

with computers.[331] By contrast, one commenter supported mandating electronic submission for environmental and cost reasons.[332]

A number of commenters did not take issue with our proposed process but suggested specific modifications to the proposed forms. Recommendations included:

- Revising the forms to accommodate joint submissions by more than one person.[333]
- Adding a checkbox to the current TCR form to effectively allow complainants to elect whistleblower status.[334]
- Removing the question concerning the whistleblower's occupation from the TCR form.[335]
- Amending Form WB-DEC to include a question as to whether the whistleblower reported the matter to a company's internal compliance reporting system.[336]
- Revising Item 3 on proposed Form TCR, which asked whether the potential whistleblower held any of a list of positions at the company, to add "company counsel" to the list.[337]

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331 Letter from Georg Merkl.

332 Letter from Continewity LLC.

333 Letter from Grohovsky Group. This commenter also was of the view that the rules should recognize that there are two distinct situations where more than one person might be considered a "whistleblower" with respect to an enforcement action: "(1) when two or more persons make a joint submission, or (2) when two or more persons, not acting in concert with each other, make submissions at different times that relate to the same enforcement action." In the latter situation, the commenter suggested that there should be a mechanism to encourage those persons to reach an agreement with each other so that, at some point, they can proceed jointly.

328 Letter from Jane Liu and Michael Lawrence.

335 Letter from Auditing Standards Committee.

336 *See, e.g.,* letters from SIFMA; ICI; Society of Corporate Secretaries.

- Adding an item to Proposed Form WB-DEC that requires whistleblowers to identify whether and to what extent the information they are providing was obtained from any lawyer working for or on behalf of the entity that is the subject of the complaint.[338]
- Replacing the phrase "compliance officers" in the instructions for completing Form TCR with the phrase "compliance professionals" to make clear that the question is intended to capture others performing compliance-related functions in companies.[339]

Finally, several commenters advanced what may be characterized as policy-type recommendations for operation of the whistleblower program. [340] Although these comments do not require specific changes to the proposed rules, we have considered them and anticipate that, where appropriate, we will incorporate some of the suggestions in implementing policies and procedures for our whistleblower program.

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[337] Letter from Auditing Standards Committee ("Knowing from the initial form whether the whistleblower was counsel to a company makes sense as a threshold review issue, and could serve as an important first indicator to the Commission staff reviewing the form that the whistleblower's complaint involved potentially privileged information and documents.")

[338] Letter from Auditing Standards Committee (a specific question "that could elicit whether counsel was the source of information would greatly enhance the staff's ability to identify the risk of receiving privileged information and would be an appropriate means of balancing the Commission's interest in receiving information with the need to protect the privilege... "Knowing this information would allow the Commission staff to quickly and efficiently segregate the report for more detailed review and consideration and should present no additional burdens on whistleblowers seeking to submit the form...It seems appropriate to exclude any illegally obtained information, whether domestically or abroad.")

[339] Letter from Murphy.

[340] *See, e.g.,* Georg Merkl (rules should require staff to inform potential whistleblowers who submit information that they may be eligible for an award and provide them with information about the program); Harold Burke (Commission should assign case officers to all filed matters, require staff to provide annual updates to whistleblowers and require at least one face-to-face meeting with a whistleblower); Wanda Bond (Commission should provide date and time-stamped receipt of information received from whistleblowers and establish mechanism by which whistleblowers can check the status of their claims).

c. Final Rule

After considering the comments, we have adopted a more streamlined process for submission of information that eliminates the requirement of a separate Form WB-DEC and requires the submission of only one form -- Form TCR -- signed under penalty of perjury. Form TCR essentially combines the key questions posed in Proposed Form TCR and Proposed Form WB-DEC into a single form. By consolidating the two forms, we have simplified the process by eliminating the burden on whistleblowers of having to file a second form and eliminating some duplicative questions that appeared on both proposed forms. Rule 21F-9(b) provides that, to be eligible for an award, a whistleblower at the time he submits his TCR must declare under penalty of perjury that the information he is providing is true and correct to the best of his knowledge and belief.

In response to comments, we also made several modifications to Form TCR. Specifically, we revised Form TCR to allow for joint submissions by more than one whistleblower. This comports with the intent of Section 21F, which defines "whistleblower" as "any individual, or 2 or more individuals acting jointly, who provides information relating to a violation of the securities laws to the Commission..."

In addition, to address commenters' concerns regarding the receipt by the Commission of potentially privileged information, we added "counsel" to the list of positions held by a whistleblower, and amended Item 8 on Proposed Form TCR (renumbered as item 10 in the form as adopted), which asks the whistleblower to describe how he or she obtained the information that supports the claim, to identify with particularity any information submitted by the whistleblower that was obtained from an attorney or in a communication where an attorney was present. As explained in our proposing release, the attorney-client privilege could be undermined if the whistleblower award program created monetary incentives for counsel to disclose information about potential securities violations that they learned of through privileged communication. In our view, a specific question that could elicit whether counsel was the source of information would enhance the staff's ability to identify the risk of receiving privileged information and would be an appropriate means of balancing the Commission's interest in receiving information with the policy goal of protecting the privilege. In addition, knowing this information would allow the staff to quickly segregate the information for more detailed review and consideration.

As discussed elsewhere, several provisions in our rules encourage, but do not require, whistleblowers to utilize their companies' internal compliance and reporting systems when appropriate. In response to comments urging us to include a question on our form asking whether the whistleblower reported the matter to a company's internal compliance program, and to address those instances in which a whistleblower <u>chooses</u> to report the violation internally, we amended questions 4a and 4b of proposed Form TCR, which asked the whistleblower to provide details about any prior action taken regarding the complaint, to specifically state whether the whistleblower reported the violation to his or her supervisor, compliance office, whistleblower hotline, ombudsman, or any other available mechanism at the entity for reporting violations. This language borrows from the instructions to question 4a on Proposed Form TCR.

Finally, we added an optional question to Form TCR to enable the whistleblower to identify any particular documents or other information in the submission that the whistleblower believes could reasonably be expected to reveal his or her identity. The purposes of this question is to afford whistleblowers who wish to remain anonymous the opportunity to guard documents or information which, if shown to a third party, may reasonably be expected to reveal their identity. It would also assist the investigative staff utilizing the information in making this determination.[341]

As to the submission of Form TCR, we agree with commenters' suggestion that we should require submissions of information made pursuant to our whistleblower program to be made under penalty of perjury, and accordingly, are requiring that the form be accompanied by sworn certifications by the whistleblower and counsel. We are not adopting the recommendation that all whistleblower submissions be certified by third party professionals because we think that the requirement is inconsistent with our user-friendly mandate and would unnecessarily add to a whistleblower's financial burden of submitting a tip to the Commission. Moreover, in our view, the requirement of a certification by the whistleblower or, in case of anonymous submission, the whistleblower's counsel, is sufficient to deter false or meritless submissions.

In response to comments that the counsel certification places an undue burden on counsel for anonymous whistleblowers, we have amended the counsel certification provision to include the phrase "true, correct and complete to the best of [counsel's] knowledge, information and belief." The addition of this phrase makes clear that we will not hold attorneys accountable if they possess a good-faith belief that the information they are submitting on behalf of the whistleblower is true, correct and complete. The

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[341] The Commission will reach its own conclusion about whether the information that the whistleblower identifies in fact could be reasonably expected to reveal the whistleblower's identity, but we believe this analysis could be significantly aided by a whistleblower's identification of documents that he or she believes might reasonably reveal his or her identity.

addition of this phrase also achieves consistency with the whistleblower's certification, which contained this language.

Form TCR as adopted also includes in the counsel certification a representation by the attorney representing an anonymous whistleblower that the attorney has "obtained the whistleblower's non-waiveable consent to provide the Commission with his or her original signed Form TCR upon request in the event that the Commission requests it "due to concerns that the whistleblower may have knowingly and willfully made false, fictitious, or fraudulent statements or representations, or used any false writing or document knowing that the writing or document contains any false fictitious or fraudulent statement or entry." Moreover, the certification reflects the attorney's consent to be legally obligated to do so within 7 calendar days of receiving such a request from the Commission. We believe that this modification to the attorney certification is necessary to effectuate the "penalty of perjury" provision in the whistleblower's declaration, and to enable the Commission to enforce the provision in appropriate cases.

Although some commenters recommended that we require attorneys to certify that the client can show "particularized facts suggesting a reasonable probability" that a securities violation has actually occurred or is occurring, we have decided not to adopt this standard. In our view, requiring attorneys to verify the form for completeness and accuracy and certify that the information is true, correct and complete to the best of the attorney's knowledge, information and belief is sufficient to discourage frivolous submissions to the Commission. We further believe that a higher standard that might require a "reasonable probability" that a securities violation actually has occurred or is occurring is unnecessary in light of an attorney's already existing ethical obligations in dealing with the Commission.

With regard to other comments relating to the process for submitting information and our proposed forms, we have decided to keep the fax and mail submissions as options to ensure that whistleblowers who do not have access to a computer or who may be averse to electronic transmissions have an alternative means of submitting information to us. In addition, we made the response to item A4 of Form TCR, which asked for the whistleblower's occupation, optional.

In response to comments that we should eliminate the form requirement so as not to disqualify whistleblowers on technical grounds, we note that we address such instances elsewhere in our rules. Specifically, Rule 21F-8(a) retains the Commission's discretion to waive the procedural requirements of the rules upon a showing of extraordinary circumstances.

A. Procedure for Submitting Original Information

As adopted, paragraph (a) of Rule 21F-9 requires whistleblowers to submit their information in one of two ways: (1) through the Commission's web-based, interactive database for the submission of tips, complaints and referrals; or (2) by completing Form TCR (*Tip, Complaint or Referral)* and mailing or faxing the form to the SEC Office of the Whistleblower, 100 F Street NE, Washington, DC 20549-5631, Fax (703) 813-9322. Paragraph (b) provides that, to be eligible for an award, a whistleblower must submit his or her original information under penalty of perjury.

In instances where information is provided by an anonymous whistleblower, paragraph (c) of Rule 21F-9 provides that the attorney for the whistleblower must submit the information on the whistleblower's behalf pursuant to paragraph (a). In addition, the attorney must retain a copy of the submission, signed by the whistleblower under penalty of perjury, and must sign the counsel certification discussed above.

In response to commenters' general suggestion that we make the application process more user friendly, we have eliminated the proposed requirement that whistleblowers who made their submission after the date of enactment of Dodd-Frank but before the effective date of these rules must perfect their whistleblower status by re-submitting their information in the format required by these rules. We agree that it would be unnecessarily burdensome to require these whistleblowers to make a duplicative submission to us. To the extent that there is additional information that the TCR form might otherwise solicit and which we might desire prior to the award application phase, the staff can contact these whistleblowers (or their counsel if applicable) to obtain that information. For those whistleblowers who submitted their information anonymously during this period, however, we are requiring them to provide their attorney with a completed and signed copy of Form TCR within 60 days of the effective date of these rules. This is generally consistent with our proposed rule, and we believe that it is necessary and appropriate because, unlike whistleblowers whose identity we are aware of, we are more constrained in our ability to confirm an anonymous whistleblower's information and eligibility. We believe that requiring whistleblowers to provide their attorney within 60 days the signed declaration from the Form TCR may help ensure earlier in the process that these whistleblowers are eligible for an award and have provided truthful information to us.

Thus, as adopted, paragraph (d) provides that, if a whistleblower submitted original information in writing to the Commission after July 21, 2010 (the date of enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act) but before the effective date of these rules, the whistleblower's submission will be deemed to satisfy the requirements set forth in paragraphs (a) and (b). However, if the whistleblower submitted the information anonymously, paragraph (d) requires the whistleblower to provide his or her attorney with a completed and signed copy of Form TCR within 60 days of the effective date of these rules. In addition, the attorney must retain the signed form in his or her records, and the whistleblower must provide a copy of the signed form to the Commission staff upon request by Commission staff prior to any payment of an award to the whistleblower in connection with the submission. Notwithstanding the foregoing, paragraph (d) provides that the whistleblower must follow the procedures and conditions for making a claim for a whistleblower award described in Rules 21F-10 and F-11.

B. Form TCR

As adopted, items A1 through A3 of Form TCR request name and contact information for each whistleblower submitting the information. In instances where a whistleblower submits information anonymously, the identifying information for the whistleblower is not required, but items B1 through B4 require the name and contact information of the whistleblower's attorney. This information may also be included in the case of whistleblowers whose identities are known and who are represented by counsel in the matter. Items C1 through C4 request basic identifying information for the individual(s) or entit(ies) to which the complaint relates. Items D1 through D12 are designed to elicit details concerning the alleged securities violation. Items D1 and D2 ask the whistleblower to provide the date of the occurrence and describe the nature of the complaint. Items D3 and D4 correspond to the same-numbered items on former Proposed Form WB-DEC. Items 3a and 3b ask whether the complainant or their counsel had any prior communications with the SEC concerning the matter and, if so, the name or the person with whom they communicated. Items 4a through 4c ask whether the whistleblower has provided the same information to any other agency or organization, or whether any other agency or organization has requested the information from the whistleblower and, if so, to provide details, including the name and contact information for the point of contact at the other agency or organization, if known.

Item 5a of Section D asks whether the complaint relates to an entity of which the whistleblower is or was an officer, director, counsel, employee, consultant or contractor. Items 5b through 5d ask whether the whistleblower has reported the violation to his or her supervisor, compliance office, whistleblower hotline, ombudsman, or any other available mechanism at the entity for reporting violations.

Items 6a and 6b ask whether the whistleblower took any other action regarding the complaint and request details regarding any such action. Although our rules do not mandate internal reporting prior to providing information to the SEC, this question is designed to address instances in which a whistleblower chooses to report the violation to his or her company first and will afford such whistleblowers the opportunity to provide the Commission with any additional relevant details relating to their internal reporting.

Item D7 asks about the type of security or investment involved, the name of the issuer and the ticker symbol or CUSIP number, if applicable. Item D8 asks the whistleblower to state in detail all facts pertinent to the alleged violation and to explain his or her belief that the acts described constitute a violation of the federal securities laws. Item D9 asks for a description of all supporting materials in the whistleblower's possession and the availability and location of any additional supporting materials not in the whistleblower's possession. Item D10 asks for an explanation of how and from whom the whistleblower obtained the information that supports the claim. In addition, the whistleblower is asked to identify any information that was obtained from an attorney or in a communication where an attorney was present. Item D11 asks the whistleblower to identify any particular documents or other information in their submission that they believe could reasonably be expected to reveal their identity, and requests the whistleblower to explain the basis for his or her belief that his or her identity would be revealed if the documents were disclosed to a third party. Item D12 provides the whistleblower with an opportunity to furnish any additional information the whistleblower thinks may be relevant to his submission.

Section E of Form TCR corresponds to Section D on Proposed Form WB-DEC. Items E1 through E9 require the whistleblower to make certain representations concerning the whistleblower's eligibility for an award.[342]

[342] Item E1 asks the whistleblower to state whether he or she is currently, or was at the time the whistleblower acquired the original information that is being submitted to the SEC, a member, officer, or employee of the Department of Justice; the Securities and Exchange Commission; the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision; the Public Company Accounting Oversight Board; any law enforcement organization; or any national securities exchange, registered securities association, registered clearing agency, or the Municipal Securities Rulemaking Board. Item 2 asks the whistleblower to state whether he or she is, or was at the time the whistleblower acquired the original information being submitted to the SEC, a member, officer or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Securities Exchange Act of 1934.
Item 3 asks if the whistleblower acquired the information through the performance of an engagement required under the securities laws by an independent public accountant. Item 4 asks whether the whistleblower is providing the information pursuant to a cooperation agreement with the SEC or with any other agency or organization. In item 5, we ask the whistleblower to state whether he or she is a spouse, parent, child or sibling of a member or employee of the SEC, or whether the whistleblower resides in the

In Section F, the whistleblower is required to declare under penalty of perjury under the laws of the United States that the information contained in the form is true, correct and complete to the best of the whistleblower's knowledge, information and belief. In addition, the whistleblower acknowledges his understanding that he may be subject to prosecution and ineligible for a whistleblower award if, in his submission of information, his other dealings with the SEC, or his dealings with another authority in connection with a related action, the whistleblower knowingly and willfully makes any false, fictitious, or fraudulent statements or representations, or uses any false writing or document knowing that the writing or document contains any false, fictitious, or fraudulent statement or entry.

The counsel certification in Section G requires an attorney for an anonymous whistleblower to certify that the attorney reviewed the form for completeness and accuracy and that the attorney has verified the identity of the whistleblower on whose behalf the form is being submitted by viewing the complainant's valid, unexpired government issued identification (*e.g.*, driver's license, passport). In addition, the attorney must certify that he or she will retain an original, signed copy of the form, with Section F signed by the whistleblower, in his or her records. Finally, the attorney must indicate that the attorney has obtained the whistleblower's non-waiveable consent to

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same household as a member or employee of the SEC. Item 6 asks whether the whistleblower is providing the information before the whistleblower (or anyone representing the whistleblower) received any request, inquiry or demand that relates to the subject matter of the submission (i) from the SEC, (ii) in connection with an investigation, inspection or examination by the PCAOB, or any SRO; or (iii) in connection with an investigation by the Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority. In item 7, we ask whether the whistleblower is the subject or target of a criminal investigation or has been convicted of a criminal violation in connection with the information being submitted to the SEC and request details concerning any such investigation or conviction. Item 8 asks whether the whistleblower acquired the information being submitted to the Commission from any person described in Item E1 through E6. Item 9 requests additional details concerning the whistleblower's responses to items 1 through 8.

provide the Commission with his or her original signed Form TCR upon request in the event that the Commission requests it due to concerns that the whistleblower may have knowingly and willfully made false, fictitious, or fraudulent statements or representations, or used any false writing or document knowing that the writing or document contains any false fictitious or fraudulent statement or entry. The certification also reflects the attorney's consent to be legally obligated to do so within 7 calendar days of receiving such a request from the Commission.

J. Rule 21F-10 — Procedures for Making a Claim Based on a Successful Commission Action

a. Proposed Rule

In Proposed Rule 21F-10, we described the procedures that a whistleblower would be required to follow in order to make a claim for an award based on a Commission action, and the Commission's proposed claims review process. The proposed process would begin with the publication of a "Notice of a Covered Action" ("Notice") on the Commission's website. Whenever a judicial or administrative action brought by the Commission results in the imposition of monetary sanctions exceeding $1,000,000, the Office of the Whistleblower would cause this Notice to be published on the Commission's website subsequent to the entry of a final judgment or order in the action that by itself, or collectively with other judgments or orders previously entered in the action, exceeds the $1,000,000 threshold. If the monetary sanctions are obtained without a judgment or order -- as in the case of a contribution made pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002 -- the Notice would be published within thirty (30) days of the deposit of monetary sanctions into a disgorgement or other fund pursuant to Section 308(b) that causes total monetary sanctions in the action to exceed $1,000,000. The Commission's proposed rule would require claimants to file their claim for an award within sixty (60) days of the date of the Notice. A claimant's failure to timely file a request for a whistleblower award would bar that individual from later seeking a recovery.

Paragraph (b) of Proposed Rule 21F-10 described the procedure for making a claim for an award. Specifically, a claimant would be required to submit a claim for an award on Proposed Form WB-APP, *Application for Award for Original Information Provided Pursuant to §21F of the Securities Exchange Act of 1934*. Proposed Form WB-APP, and the instructions thereto, would elicit information concerning a whistleblower's eligibility to receive an award at the time the whistleblower files his claim. The purpose of the form is, among other things, to provide an opportunity for the whistleblower to "make his case" for why he is entitled to an award by describing the information and assistance he has provided and its significance to the Commission's successful action. Proposed Items A1 through A3 required the claimant to provide basic identifying information, including first and last name and contact information. Proposed Items B1 through B4 requested the name and contact information for the whistleblower's attorney, if applicable. Proposed Items C1 and C2 requested information concerning the original tip or complaint underlying the claim, including the TCR number, the date the information was submitted and the subject of the tip, complaint or referral. Proposed Items D1 through D3 requested information concerning the Notice of Covered Action to which the claim relates, including the date of the notice, notice number, and the name and case number of the matter to which the notice relates. Proposed Items E1 through E3 requested information concerning related actions. A whistleblower would be required to complete Section E in cases where the whistleblower's claim was submitted in connection with information submitted to another agency or organization in a related action (the questions pertaining to related actions are explained in the discussion of Proposed Rule 21F-11, below). Proposed Items F1 through F9 required the claimant to make certain representations concerning the claimant's eligibility to receive an award at the time the claim is made. In Item G, a claimant may set forth the grounds for the claimant's belief that he is entitled to an award in connection with the information submitted to the Commission, or to another agency or organization in a related action. Finally, item H contained a declaration, to be signed by the claimant, certifying that the information contained on the form is true, correct and complete to the best of the claimant's knowledge, information and belief. The declaration would further acknowledge the claimant's understanding that he may be subject to prosecution and ineligible for a whistleblower award for knowingly and willfully making any false, fictitious, or fraudulent statements or representations in his or her submission or dealings with the SEC or other authority.

Paragraph (b) of Proposed Rule 21F-10 provided that a claim on Form WB-APP, including any attachments, must be received by the Office of the Whistleblower within sixty (60) days of the date of the Notice of Covered Action in order to be considered for an award.

Paragraph (c) required a whistleblower who submitted information to the Commission anonymously to disclose his identity to the Commission on Proposed Form WB-APP and to verify his identity in a form and manner that is acceptable to the Office of the Whistleblower prior to the payment of an award. This requirement is derived from Subsection 21F(d)(2)(B) of the Exchange Act.

Paragraph (d) of Proposed Rule 21F-10 described the Commission's claims review process. The claims review process would begin once the time for filing any appeals of the Commission's judicial or administrative action has expired, or where an appeal has been filed, after all appeals in the action have been concluded.

Under the proposed process, the Office of the Whistleblower and designated Commission staff (defined in Proposed Rule 21F-10 as the "Claims Review Staff") would evaluate all timely whistleblower award claims submitted on Form WB-APP. In connection with this process, the Office of the Whistleblower could require that claimants provide additional information relating to their eligibility for an award or satisfaction of any of the conditions for an award, as set forth in Proposed Rule 21F-8(b). Following that evaluation, the Office of the Whistleblower would send any claimant a Preliminary Determination setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount.

The proposed rule would allow a claimant the opportunity to contest the Preliminary Determination made by the Claims Review Staff. Under paragraph (e) of Proposed Rule 21F-10, the claimant could take any of the following steps:

- Within thirty (30) days of the date of the Preliminary Determination, the claimant may request that the Office of the Whistleblower make available for the claimant's review the materials that formed the basis of the Claims Review Staff's Preliminary Determination.

- Within thirty (30) days of the date of the Preliminary Determination, or if a request to review materials is made pursuant to paragraph (1) above, then within thirty (30) days of the Office of the Whistleblower making those materials available for the claimant's review, a claimant may submit a written response to the Office of the Whistleblower setting forth the grounds for the claimant's objection to either the denial of an award or the proposed amount of an award. The claimant may also include documentation or other evidentiary support for the grounds advanced in his response.
- Within thirty (30) days of the date of the Preliminary Determination, the claimant may request a meeting with the Office of the Whistleblower. However, such meetings are not required and the Office of the Whistleblower may in its sole discretion decline the request.

Paragraph (f) of Proposed Rule 21F-10 made clear that if a claimant fails to submit a timely response pursuant to paragraph (e), then the Preliminary Determination of the Claims Review Staff would be deemed the Final Order of the Commission (except where the Preliminary Determination recommended an award, in which case the Preliminary Determination would be deemed a Proposed Final Determination, which would make it subject to review by the Commission under paragraph (h)). In addition, a claimant's failure to submit a timely response to a Preliminary Determination where the determination was to deny an award would constitute a failure to exhaust the claimant's administrative remedies, and the claimant would be prohibited from pursuing a judicial appeal.

Paragraph (g) of Proposed Rule 21F-10 described the procedure in cases where a claimant submits a timely response pursuant to Paragraph (f). In such cases, the Claims Review Staff would consider the issues and grounds advanced in the claimant's response, along with any supporting documentation provided by the claimant, and would prepare a Proposed Final Determination. Paragraph (h) provides that the Office of the Whistleblower would notify the Commission of the Proposed Final Determination, but would not make the Proposed Final Determination public. Within thirty (30) days thereafter, any Commissioner would be able to request that the Proposed Final Determination be reviewed by the Commission. If no Commissioner requested such a review within the 30-day period, then the Proposed Final Determination would become the Final Order of the Commission. In the event a Commissioner requested a review, the Commission would review the record that the staff relied upon in making its determination, including the claimant's previous submissions to the Office of the Whistleblower. On the basis of its review of the record, the Commission would issue its Final Order, which the Commission's Secretary will provide to the claimant.

b. Comments Received

We received a number of comments suggesting that the claims process be simplified, streamlined, or made less formal. Several commenters criticized the initial requirement that a whistleblower submit an award application within 60 days of a Notice of Covered Action.[343] These commenters generally stated that this requirement could be eliminated if the Office of the Whistleblower were required to contact whistleblowers directly to inform them that a covered action has been successfully litigated and

[343] *See, e.g.*, letters from VOICES; Grohovsky Group; NWC; Wanda Bond; False Claims Act Legal Ctr.

contended that the proposal places an undue burden on whistleblowers to monitor the SEC website to learn of their potential eligibility for an award.[344]

A few commenters stated that claims resolution process should be less formal and more focused on reaching a negotiated settlement. One such comment asserted that the procedures for determining awards seemed "overly formalistic," noting that negotiation has been highly effective in resolving issues in *qui tam* cases under the False Claims Act.[345] Another commenter recommended that a settlement process be built into the claims resolution process.[346]

Finally, several commenters suggested additional procedures or guidance that we could employ to assist whistleblowers with the claims process. One commenter recommended that the application form should be simplified.[347] Another commenter recommended that we send whistleblowers a checklist of any further requirements once the whistleblower submits information, including how and where the whistleblower can find the 'Notice of Covered Action' on the SEC's website and a contact for any further questions.[348] This commenter also recommended that we provide a method for whistleblowers to check on the progress of the claims process.[349]

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344 *See* letters from VOICES; Grohovsky Group; False Claims Act Legal Center.

345 *See* letter from Grohovsky Group.

346 *See* letter from NWC.

347 *See* letter from NWC (recommending that a whistleblower should submit a "simplified form, consistent with the form recommended by the Inspector General," rather than the proposed WB-APP).

348 *See* letter from Wanda Bond.

349 *See* letter from Wanda Bond.

c. Final Rule

After reviewing the comments, we are adopting the rule with several modifications.

We have decided not to eliminate the Notice of Covered Action or to otherwise model the procedures after those employed in the *qui tam* context. The *qui tam* context is substantially different from our situation because *qui tam* actions necessarily will involve one or more known relators with whom the Department of Justice will have worked. By contrast, in enforcement actions that we institute and litigate (based in part on information and assistance from one or more whistleblowers), there may be one whistleblower with whom we have worked closely, but other claimants who have a potential basis for award eligibility as well. Our procedures must provide due process to all potential claimants and accordingly cannot be tailored only to those claimants with whom the staff has worked closely. For that reason, we believe the "Notice of Covered Action" procedure provides the best mechanism to provide notice to all whistleblower claimants who may have contributed to the action's success. Nevertheless, we anticipate that the Office of the Whistleblower's standard practice will be to provide actual notice to whistleblowers with whom the staff has worked closely. We also believe the application form, preliminary determination, opportunity for response, and final determination together should operate to ensure that all potential claimants have a fair opportunity to pursue an award claim. A more informal process modeled after the *qui tam* procedures might favor those whistleblowers who have worked closely with our staff and might not provide a full and fair opportunity for claims by others who nonetheless may have provided original information that led to the successful covered action.[350]

Nonetheless, to respond to some of the concerns raised by commenters and to make the process more accessible to whistleblowers, we have made several modifications in the final rule. First, we have decided to increase the period for claimants to file their claim for an award from sixty (60) days to ninety (90) days. This additional time should provide claimants with a better opportunity to review the Commission's website and file an application following the publication of a Notice. In our view, this 90-day period strikes an appropriate balance between competing whistleblower interests – allowing all potential whistleblowers a reasonable opportunity to periodically review the Commission's website and to file an application, on the one hand, but providing finality to the application period so that the Commission can begin the process of assessing any applications and making a timely award to any qualifying whistleblowers, on the other hand.[351]

Second, in light of comments that we simplify the WB-APP form, we have made Section G of the form optional. As commenters stated, when a whistleblower has

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350 In addition, in those situations where the Claims Review Staff determines that it may be appropriate, the rule provides the Office of the Whistleblower with a mechanism to engage in discussions with known whistleblowers. Indeed, paragraph (e)(1)(ii) provides claimants with an opportunity to request a meeting with the Office of the Whistleblower following a Preliminary Determination. The Office of the Whistleblower could use these meetings in appropriate cases as an opportunity to reach a tentative agreement with a meritorious whistleblower on the terms of a Proposed Final Determination, which could then be presented to the Commission for approval.

351 Two commenters asserted that there is no support in the statute for a rule barring a whistleblower from obtaining an award if he fails to file a timely claim after the 60-day notice. *See* letter from VOICES. *See also* letter from False Claims Act Legal Center. We disagree. The statutory authority to adopt rules necessary or appropriate to implement the awards program, which is contained in Section 21F(j), plainly permits the Commission to establish procedures for submitting information and making claims for awards. See also Section 21F(b)(1) (providing for payments "under regulations promulgated by the Commission"). The 90-day bar provides finality at the end of a reasonable application period so that we may assess the award applications and conclusively determine which applicant, if any, is entitled to an award, and in what percentage amount.

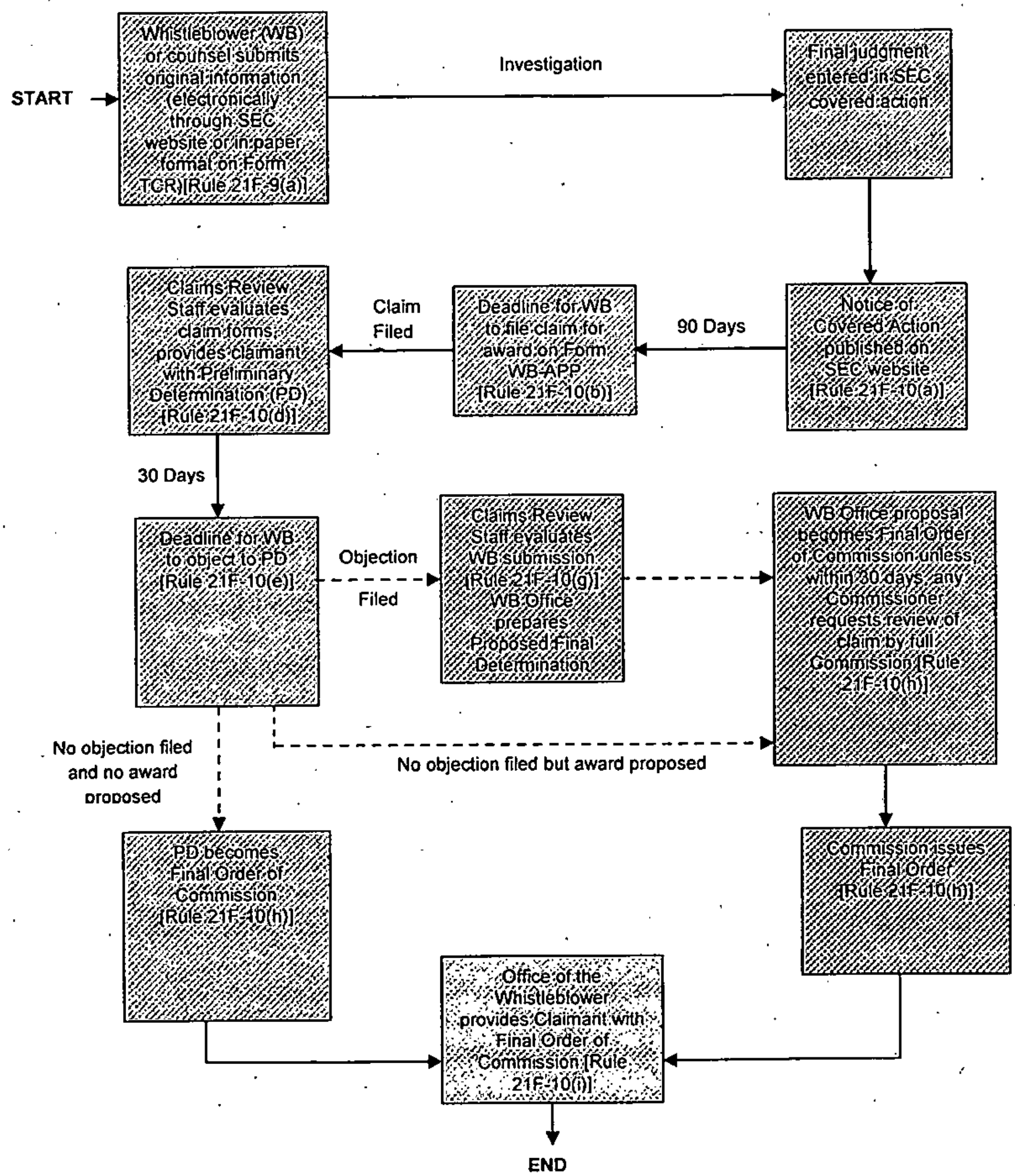
worked closely with the staff on a matter, requiring that whistleblower to furnish a submission explaining the degree and value of his or her assistance may well be unnecessary. At the same time, such a whistleblower – or other claimants who have not worked as closely with the staff and wish to advocate the value of their assistance – should have the opportunity to do so. We have determined not to make any further modifications to the form, however, because the remaining information that we request is in our view necessary so that we have a sufficient record to consider the claimant's application (and, if a petition for review is filed, so that the court of appeals has a sufficient record to conduct a review).

Third, in paragraph (d), we have provided the Director of Enforcement with express authority to designate the staff members to serve on the Claims Review Staff. The Director of Enforcement may designate staff from the Enforcement Division, the Office of the Whistleblower, or other Commission divisions or offices to serve on the Claims Review Staff, either on a case-by-case basis or for fixed periods, as the Director deems appropriate.

Fourth, in paragraph (e), we have clarified that any response a claimant files to a Preliminary Determination must be in a form and manner that the Office of the Whistleblower shall require. Fifth, in paragraph (e)(1)(i), we have added a reference to new Rule 21F-12, clarifying that a claimant can request that the Office of the Whistleblower make available for his or her review the materials from among those set forth in Rule 21F-12 that the Claims Review Staff used as the basis for its Preliminary Determination.[352]

[352] We have also revised final rule 21F-10 (and made a corresponding revision in final rule 21F-11) to provide that the Final Order of the Commission will be provided to a claimant by the Office of the

The following chart represents a general overview of the process that we are adopting:




Whistleblower instead of the SEC Office of the Secretary (although the Office of the Secretary will continue to issue the Order). We have done so to reflect the fact that the Office of the Whistleblower is the appropriate Commission liaison with whistleblower claimants.

K. Rule 21F-11 — Procedure for Making a Claim Based on a Successful Related Action

a. Proposed Rule

Proposed Rule 21F-11 set forth the procedures for determining awards based upon related actions. Paragraph (a) of Proposed Rule 21F-11 informed a whistleblower who is eligible to receive an award following a Commission action that results in monetary sanctions totaling more than $1,000,000 that the whistleblower may also be eligible to receive an award based on the monetary sanctions that are collected from a related action.

Paragraph (b) of Proposed Rule 21F-11 described the procedures for making a claim for an award in a related action. The process essentially mirrored the procedure for making a claim in connection with a Commission action and would require the claimant to submit the claim on Form WB-APP. In addition to the questions previously described in our discussion of Proposed Rule 21F-10, the claimant in a related action would be required to complete Section D of Proposed Form WB-APP. Proposed Items D1 through D4 requested the name of the agency or organization to which the whistleblower provided the information and the date the information was provided, the name and telephone number for a contact at the agency or organization, if available, and the case name, action number and date the related action was filed.

Paragraph (b) of Proposed Rule 21F-11 set forth the deadline by which a claimant must file his or her Form WB-APP in a related action. Specifically, under proposed paragraph (b)(1), if a final order imposing monetary sanctions has been entered in a related action at the time the claimant submits the claim for an award in connection with a Commission action, the claimant would be required to submit the claim for an award in that related action on the same Form WB-APP used for the Commission action. Under proposed paragraph (b)(2), if a final order imposing monetary sanctions in a related action has not been entered at the time the claimant submits a claim for an award in connection with a Commission action, then the claimant would be required to submit the claim on Form WB-APP within sixty (60) days of the issuance of a final order imposing sanctions in the related action.

The proposed rule provided that the Office of the Whistleblower may request additional information from the claimant in connection with the claim for an award in a related action to demonstrate that the claimant directly (or through the Commission) voluntarily provided the governmental agency, regulatory authority or self-regulatory organization the same original information that led to the Commission's successful covered action, and that this information led to the successful enforcement of the related action. In addition, the Office of the Whistleblower may, in its discretion, seek assistance and confirmation from the other agency in making this determination.

Paragraphs (d) through (i) of Proposed Rule 21F-11 described the Commission's claims review process in related actions. The Commission proposed to utilize the same claims review process in related actions that it would utilize in connection with claims submitted in connection with a covered Commission action.

b. Comments Received

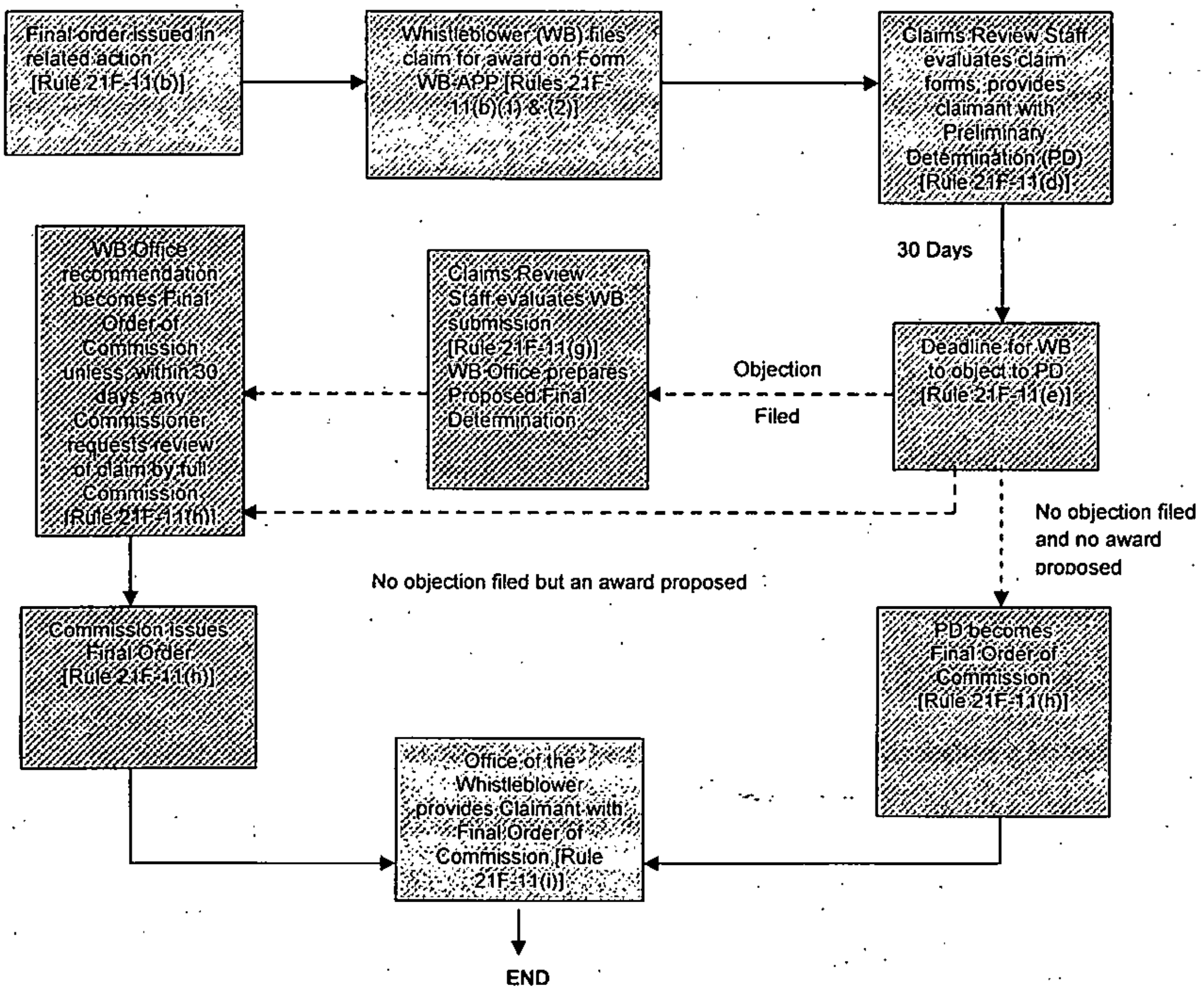
The Commission did not receive any comments directed specifically to this proposed rule. Nonetheless, several of the comments on Rule 21F-10 –those recommending that we employ certain additional procedures or guidance to assist whistleblowers with the claims process – are also relevant to Rule 21F-11.

c. Final Rule

We are adopting Rule 21F-11 with several modifications, which parallel certain of the changes we made to Rule 21F-10.

First, in paragraph (b)(2), we have extended to ninety (90) days the period that a whistleblower has to file a claim following the entry of a final order imposing monetary sanctions in a related action where the entry of the final order occurs after the whistleblower has submitted a claim for an award in the Commission's covered action. This gives whistleblowers a longer time in which to file a claim, reducing the likelihood that a meritorious whistleblower would miss the filing deadline. Second, in paragraph (e), we have clarified that any response a claimant files to a Preliminary Determination must be in a form and manner that the Office of the Whistleblower shall require. Third, in paragraph (e)(1)(i), we have added a reference to new Rule 21F-12, clarifying that a claimant can request that the Office of the Whistleblower make available for his or her review the materials from among those set forth in Rule 21F-12 that the Claims Review Staff used as the basis for its Preliminary Determination.

The following chart represents a general overview of the process that we are adopting:




L. <u>Rules 21F-12 & 13 – Materials that May Be Used as the Basis for an Award Determination and that May Comprise the Record on Appeal; Right of Appeal</u>

a. Proposed Rule

In Proposed Rule 21F-12, we described claimants' appeal rights and designated the materials that could comprise the record on appeal.

We intended paragraph (a) of the proposed rule to track Section 21F(f) of the Exchange Act, which provides for certain rights of appeal of Commission orders with respect to whistleblower awards. Under Section 21F, a decision of the Commission regarding the amount of an award would not be appealable when the Commission has followed the statutory mandate to award between 10 and 30 percent of the monetary sanctions collected after taking into consideration the criteria established under Section 21F(c)(1)(B) of the Act. A decision regarding whether or to whom to make an award could be appealed to an appropriate court of appeals within 30 days after the Commission issues its final decision. Under Section 25(a)(1) of the Exchange Act, appeals of final orders of the Commission entered pursuant to the Exchange Act could be made to the United States Court of Appeals for the District of Columbia Circuit, or to the circuit where the aggrieved person resides or has his principal place of business.

Paragraph (b) of the proposed rule designated the materials that comprise the record on appeal. These included the Claims Review Staff's Preliminary Determination, any materials submitted by the claimant or claimants (including the claimant's Forms TCR, WB-DEC, WB-APP, and materials filed in response to the Preliminary Determination), and any other materials that supported the Final Order of the Commission, with the exception of any internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim, such as the staff's Proposed Final Determination in the event it does not become the Final Order.

Other than the materials identified for inclusion in the record on appeal, the proposed rule provided the Claims Review Staff and the Commission with discretion on a case-by-case basis to determine the materials that could be relied upon to form the award determination.[353]

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[353] *See, e.g.*, Proposed Rule 21F-10(e)(1)(i); Proposed Rule 21F-11(e)(1)(i).

b. Comments Received

We received only a few comments on this proposal. One commenter stated that the proposed rule unduly restricted the whistleblower's appeals rights by foreclosing judicial review of the Commission's determination of the amount of the award and claims of abuse of discretion in applying the statutory criteria set forth in Dodd-Frank 922(f).[354] Another commenter recommended that the rule should include a provision to permit a whistleblower who is wrongfully denied a reward to obtain, as a matter of course, attorney's fees under the Equal Access to Justice Act if the claimant prevails on appeal.[355] A third commenter criticized our proposal to the extent that it would not make available internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim.[356]

c. Final Rule

After reviewing the comments, we are adopting a new Rule 21F-12 that specifies the material that may form the record of the Commission's award determination, and rule 21F-13, concerning appeals, which substantially follows proposed rule 21F-12.

Rule 21F-12(a) specifies the materials that we may rely upon to form the basis for an award determination. We believe that specifying the materials that we may rely upon will promote transparency and consistency in the claims review process. Under Rule 21F-12(a), the Commission and staff may rely on the following items:

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354 *See* letter from False Claims Act Legal Center (citing Senate Report No. 111–176, at 112 (April 30, 2010)).

355 *See* letter from NWC.

356 *See* letter from Eric Dixon.

- Any publicly available materials from the covered action or related action, including (i) the complaint, notice of hearing, answers and any amendments thereto; (ii) the final judgment, consent order, or final administrative order; (iii) any transcripts of the proceedings, including any exhibits; (iv) any items that appear on the docket; and (v) any appellate decisions or orders.
- The whistleblower's Form TCR, including attachments, and other related materials provided by the whistleblower to assist the Commission with the investigation or examination.
- The whistleblower's Form WB-APP, including attachments, and any other filings or submissions from the whistleblower in support of the award application.
- Sworn declarations (including attachments) from the Commission's staff regarding any matters relevant to the award determination.
- With respect to an award claim involving a related action by another entity, any statements or other information that the entity provides or identifies in connection with an award determination. However, we will not consider any materials if the entity that provided them has not authorized us to share the information with the claimant, because we do not believe it would be fair or appropriate to rely upon information that may not be made available to the claimant.[357]

[357] For instance, if a state Attorney General should provide us with information to assist us in processing a whistleblower claim, but should expressly tell us that the information is highly sensitive and may not be shared with the whistleblower because it might jeopardize on-going criminal law enforcement

- Any other documents or materials including sworn declarations from third-parties that are received or obtained by the Office of the Whistleblower to assist us in resolving the claimant's award application, including information related to the claimant's eligibility (provided that we are also permitted to share it with the claimant).[358]

Rule 21F-12(b) provides that a claimant is not entitled to obtain any materials beyond those that form the basis of an award determination, including "pre-decisional or internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim." The proposed rules did not provide claimants with an opportunity to review materials that we did not rely upon to form the basis for an award determination, and Rule 21F-12(b) simply clarifies that claimants are not entitled to obtain these materials.[359]

In Proposed Rule 21F-12(b) (which is now Final Rule 21F-13(b)), we provided that a claimant is not entitled to include pre-decisional material in the record on appeal, and we are now further clarifying in Rule 21F-12(b) that a claimant is not entitled to receive those materials from the Commission. We do not agree with the suggestion that internal deliberative process materials that are prepared exclusively to assist the Commission's decisional process should be included within the record on appeal.

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investigations, we will not rely on the particular information in processing the whistleblower's claim because we cannot also share the information with the claimant.

[358] For instance, if a third party should voluntarily provide us with information related to a whistleblower's claim, but expressly request that we not disclose the information to the claimant for fear the claimant would realize the third-party had been the source, we will not rely on the particular information because we cannot also share it with the claimant.

[359] *See, e.g.*, Proposed Rule 21F-10(e)(1)(i); Proposed Rule 21F-11(e)(1)(i). *See also* Proposed Rule 21F-12(b).

These materials are by their nature pre-decisional work product that may often contain the staff's "frank discussion of legal and policy making materials,"[360] and the disclosure of these materials would have a chilling effect on our decision-making process.[361]

Rule 21F-12(b) also consolidates provisions from Proposed Rules 21F-10(e)(1)(i) and 21F-11(e)(1)(i) that provide that the Office of the Whistleblower may: (1) make redactions as necessary to comply with any statutory restrictions, to protect the Commission's law enforcement and regulatory functions, and to comply with requests for confidential treatment from other law enforcement and regulatory authorities; and (2) require a claimant to sign a confidentiality agreement before providing these materials.

We are adopting Rule 21F-13(a) -- which substantially tracks Proposed Rule 21F-12(a) -- to clarify that when the Commission makes an award between 10 and 30 percent, and that determination is based on the factors set forth in Rule 21F-6, our final order regarding the amount of an award (including the award allocation among multiple whistleblowers) is not appealable. The proposing rule had not expressly stated that the award determination must be based on a consideration of the factors in Rule 21F-6, but we believe this clarification ensures that the rule is consistent with Section 21F(f) of the Exchange Act. We have further clarified that, consistent with Section 21F(f), "any

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[360] *See, e.g., NLRB v. Sears, Roebuck & Co.*, 421 U.S. 132, 151 (1975); *see also United States v. Farley*, 11 F.3d 1385, 1389 (7th Cir. 1993) ("[F]rank discussion of legal and policy matters is essential to the decision-making process of a governmental agency."); *Town of Norfolk v. U.S. Army Corps of Eng'rs*, 968 F.2d 1438, 1458 (1st Cir. 1992).

[361] *See generally Dep't of Interior v. Klamath Water Users Protective Ass'n*, 532 U.S. 1, 8–9 (2001) (stating that the "deliberative process privilege rests on the obvious realization that officials will not communicate candidly among themselves if each remark is a potential item of discovery and front page news").

factual findings, legal conclusions, policy judgments, or discretionary assessments" that we make in considering the Rule 21F-6 factors are *not* appealable.[362]

We are adopting Rule 21F-13(b) -- which substantially tracks Proposed Rule 21F-12(b); however, we have modified the proposed language to clarify that the record on appeal shall consist of the Preliminary Determination, the Final Order of the Commission, and any other items from among those set forth in Rule 21F-12(a) that either the Commission *or the claimant* identifies for inclusion in the record. We believe that this modification is appropriate because it expressly provides the claimant with an opportunity to designate items for the appellate record from among those items set forth in Rule 21F-12(a).

Finally, with respect to the suggestion that we include a provision that would afford attorneys' fees pursuant to the Equal Access to Justice Act to a claimant any time he or she prevails on appeal, we believe that this would be inconsistent with EAJA's substantive terms,[363] which set forth the specific circumstances under which a prevailing party may obtain attorney's fees.

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[362] Although one commenter cited to legislative history to contend that we are unduly restricting the scope of appeals under Section 21F(f), the legislative history identified in fact refers to an earlier draft of the bill that became the Dodd-Frank Act. That provision was subsequently changed before it was incorporated into the Dodd-Frank Act so that it expressly precluded appeal of an award amount where the Commission considered the relevant factors in assessing the award. *See* 156 Cong. Rec. S5929 (daily ed. July 15, 2010) (statement of Sen. Dodd) ("amended to eliminate the right of a whistleblower to appeal the amount of an award.") Indeed, the relevant provision of the earlier draft of the bill did not, unlike Section 21F(f), include language that expressly excluded from the scope of appeal "the determination of the amount of an award if the award was based on a consideration of the" awards factors.

[363] *See, e.g.*, Equal Access to Justice Act (EAJA) 28 U.S.C. 2412(d)(1)(A) ("[A] court shall award to a prevailing party other than the United States fees and other expenses . . . incurred by that party in any civil action (other than cases sounding in tort), including proceedings for judicial review of agency action, brought by or against the United States in any court having jurisdiction of that action, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust.").

## M. Rule 21F-14 – Procedures Applicable to Payment of Awards

Proposed Rule 21F-13 addressed the procedures for payment of awards to whistleblowers. After considering the comments on this proposal, we are adopting the rule as proposed, except that we are redesignating the rule as Rule 21F-14.

### a. Proposed Rule

Paragraph (a) of the proposed rule provided that any award made pursuant to the rules would be paid from the Securities and Exchange Commission Investor Protection Fund (the "Fund") established by Section 21F(g) of the Exchange Act.[364] Paragraph (b) provided that a recipient of a whistleblower award would be entitled to payment on the award only to the extent that a monetary sanction is collected in the Commission action or in a related action upon which the award is based. Both of these provisions derive from language in Section 21F(b) of the Exchange Act.[365]

Paragraph (c) addressed the timing for payment. It stated that any payment of an award for a monetary sanction collected in a Commission action would be made following the later of either the completion of the appeals process for all whistleblower award claims arising from the Notice of Covered Action for that action, or the date on which the monetary sanction is collected. Likewise, the payment of an award for a monetary sanction collected in a related action would be made following the later of either the completion of the appeals process for all whistleblower award claims arising from the related action, or the date on which the monetary sanction is collected.

Paragraph (d) of the proposed rule described how the Commission would address situations where there are insufficient amounts available in the Fund to pay an

[364] 15 U.S.C. 78u-6(g).

[365] 15 U.S.C. 78u-6(b).

award to a whistleblower or whistleblowers within a reasonable period of time of when payment otherwise should be made. In general, the provision specified the priority among whistleblowers for payment when amounts become available in the Fund to pay awards.

b. Comments Received

We received only a few comments on the payment procedures under proposed rule 21F-13 and our request for comment on the possibility that whistleblowers could be paid with monies that otherwise could be distributed to victims pursuant to a Commission action.[366]

One commenter stated that it was improper to reward whistleblowers at the expense of victims and suggested that the Commission consider the interests of victims first and reward whistleblowers only after victims have been made whole.[367] Another commenter believed that the tension between paying an award to a whistleblower and compensating victims is unlikely to occur given the present balance of the Fund, but suggested that, if the tension did arise, the Commission could defer paying an award to a whistleblower until all victims have been compensated, or alternatively, ask the whistleblower to voluntarily defer payment of an award until all victims have been compensated.[368] A third commenter stated that the Commission should make sure that

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[366] 15 U.S.C. 78u-6(g)(3)(B). That possibility arises from a provision in the law that requires the Commission to deposit into the Fund an amount equal to the unsatisfied portion of a whistleblower award from any monetary sanction collected by the Commission in the Commission action on which the award is based if the balance of the Fund is not sufficient to satisfy the award.

[367] *See* letter from Americans for Limited Government.

[368] *See* letter from Georg Merkl.

the IRS is notified of any payments to whistleblowers and that any award recipient receives a Form 1099.[369]

c. Final Rule

After reviewing and considering the comments, we are adopting Rule 21F-13 as proposed, except that we are redesignating the rule as Rule 21F-14.

We are sympathetic to the commenters' concern that in some circumstances whistleblowers might be paid with monies that otherwise could be distributed to victims pursuant to a Commission action. That possibility is a consequence of the whistleblower statute, however, not the rule. Moreover, deferring payment to a whistleblower would not resolve this issue. If there are insufficient amounts in the Fund to pay a whistleblower award, the statute requires that monies needed to satisfy the award be deposited into the Fund from any monies collected in the Commission action on which the award is based. Once deposited into the Fund, these monies can be paid only to a whistleblower (or for specified purposes to the SEC's Inspector General), not to victims. Deferring payment to a whistleblower would not free up these monies to compensate victims first. Accordingly, we are constrained by the funding mechanism established in the whistleblower statute, and do not believe that the issue can be resolved through payment procedures.[370]

As in the proposed rule, paragraph (a) of the rule that we are adopting today provides that any award made pursuant to the rules will be paid from the Fund. This

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369 *See* letter from John Wahh.

370 We agree with the comment that we notify the IRS and issue Form 1099 for any whistleblower payment, but we do not believe that any change to the rule is necessary to accomplish this. We expect to issue Form 1099-MISC to each whistleblower and the IRS upon payment of an award to a whistleblower who is not a foreign national. We will coordinate with the IRS regarding the tax filing requirements that may be applicable to the payment of an award to a whistleblower who is a foreign national.

provision derives directly from Section 21F(b)(2) of the Exchange Act, which states that any amount paid to a whistleblower shall be paid from the Fund.[371] Paragraph (b) provides that a recipient of a whistleblower award is entitled to payment on the award only to the extent that a monetary sanction is collected in the Commission action or in a related action upon which the award is based.[372] This requirement derives from Section 21F(b)(1) of the Exchange Act, which provides that an award is based upon the monetary sanctions collected in the Commission action or related action.[373]

Paragraph (c) of the final rule, like the proposed rule, provides that any payment of an award for a monetary sanction collected in a Commission action will be made following the later of either the completion of the appeals process for all whistleblower award claims arising from the Notice of Covered Action for that action, or the date on which the monetary sanction is collected. Likewise, the payment of an award for a monetary sanction collected in a related action would be made following the later of either the completion of the appeals process for all whistleblower award claims arising from the related action, or the date on which the monetary sanction is collected. This provision is intended to cover situations where a single action results in multiple whistleblower claims. In that circumstance, if one whistleblower appealed a Final Determination of the Commission denying the whistleblower's claim for an award, the

[371] 15 U.S.C. 78u-6(b)(2).

[372] Where the Commission receives a monetary sanction that is deemed satisfied by payment of a separate money judgment obtained by an entity described in Rule 21F-3(c)(1) – i.e., a payment in a "related action" -- the monetary sanction will not be counted as having been collected in both the Commission action and in the related action.

[373] 15 U.S.C. 78u-6(b)(1). We note that, if monetary sanctions are ordered to be paid in a Commission or related action, but payment is waived, in whole or in part, for inability to pay or for other reasons, payment to a whistleblower is made only with respect to the amounts actually collected in such action. However, this does not affect whether the $1,000,000 monetary sanctions threshold is satisfied for purposes of qualifying as a covered action.

Commission would not pay any awards in the action until that whistleblower's appeal has been concluded, because the disposition of that appeal could require the Commission to reconsider its determination and thereby could affect all payments for that action.

Finally, as in the proposed rule, paragraph (d) of the final rule describes how the Commission will address situations where there are insufficient amounts available in the Fund to pay an award to a whistleblower or whistleblowers within a reasonable period of time of when payment should otherwise be made. In this situation, the whistleblower or whistleblowers will be paid when amounts become available in the Fund, subject to the terms set forth in paragraphs (d)(1) and (d)(2). Under paragraph (d)(1), where multiple whistleblowers are owed payments from the Fund based on awards that do not arise from the same Notice of Covered Action or related action, priority in making payment on these awards will be determined based upon the date that the collections for which the whistleblowers are owed payments occurred. If two or more of these collections occur on the same date, those whistleblowers owed payments based on these collections will be paid on a pro rata basis until sufficient amounts become available in the Fund to pay their entire payments. Under paragraph (d)(2), where multiple whistleblowers are owed payments from the Fund based on awards that arise from the same Notice of Covered Action or related action, they will share the same payment priority and will be paid on a pro rata basis until sufficient amounts become available in the Fund to pay their entire payments.

N. Rule 21F-15 - No Amnesty

a. Proposed Rule

Proposed rule 21F-14 stated that the provisions of Section 21F of the Exchange Act do not provide whistleblowers with amnesty or immunity for their own misconduct. However, the proposed rule noted that the Commission will take whistleblowers' cooperation into consideration in accordance with its Policy Statement Concerning Cooperation by Individuals in [SEC] Investigations and Related Enforcement Actions (17 CFR § 202.12).

b. Comments Received

We received few comments on this proposed rule. All of the commenters urged the Commission to adopt a liberal approach to granting amnesty to whistleblowers.[374] One commenter suggested that there will be a large group of high-quality potential whistleblowers that have concerns about their potential liability and will not come forward to report securities violations without assurances that they will not be civilly or criminally prosecuted.[375] Another commenter stated that there should be no firm rule on amnesty.[376]

c. Final Rule

We are adopting the proposed rule without modification, except that we have redesignated it as Rule 21F-15. The final rule provides notice that whistleblowers will not automatically receive amnesty if they provide information about securities violations

[374] *See, e.g.,* letters from NWC, John Wahh and Stuart D. Meissner, LLC.

[375] *See* letter from Stuart D. Meissner, LLC.

[376] *See* letter from NWC.

to the Commission. Of course, whistleblowers who have not participated in misconduct will not need amnesty.

With respect to the suggestion that we establish a process in which whistleblowers can receive amnesty or other forms of leniency, such policies and procedures have already been publicly promulgated in the "Fostering Cooperation" section of the Enforcement Manual for the Division of Enforcement. This section discusses in detail the wide spectrum of tools available to the Commission and its staff for facilitating and rewarding whistleblowers and other cooperators, ranging from taking no enforcement action to pursuing reduced charges and sanctions in connection with enforcement actions.[377]

O. Rule 21F-16 – Awards to Whistleblowers who Engage in Culpable Conduct

a. Proposed Rule

Proposed rule 21F-15 stated that, for purposes of determining whether the required $1,000,000 threshold for an award has been satisfied, the Commission would not include any monetary sanctions that the whistleblower is ordered to pay, or that an entity is ordered to pay if the entity's liability is based substantially on conduct that the whistleblower directed, planned, or initiated. The proposed rule also stated that the Commission will not include any such amounts in the total monetary sanctions collected for purposes of calculating the amount of an award payment to a whistleblower.

[377] *See* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf#6.2.

b. Comments Received

We received many comments on this proposed rule. The comments addressed whether whistleblowers' culpability in the unlawful conduct should be a basis for excluding them from eligibility for an award or reducing the amount of their awards.

Many of the commenters opposed any rule that would exclude culpable whistleblowers from eligibility for awards or would reduce the amount of their awards, reasoning that without sufficient financial incentives potential high-quality whistleblowers would not come forward and fraud schemes would go undetected or be discovered much later than they otherwise might.[378] Some commenters contended that the Commission did not have the statutory authority to exclude culpable whistleblowers from eligibility for awards beyond what is already contained in the statute -- that is, whistleblowers who are convicted of a criminal violation related to the covered action.[379] Other commenters argued that culpable whistleblowers are often "insiders" with valuable first-hand knowledge of fraudulent conduct, and as such are frequently the best sources of information about companies and senior level management involved in misconduct.[380] One commenter suggested that allowing culpable whistleblowers to be eligible for awards may also deter future misconduct because securities violators would know that they forever face an increased risk that one of their co-conspirators "might turn state's evidence against them."[381]

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378 *See, e.g.,* letters from Auditing Standards Committee, NWC and Sipio.

379 *See, e.g.,* letter from NWC.

380 *See, e.g.,* letters from Vogel, Slade & Goldstein; Kenney & McCafferty; Georg Merkl; and NWC.

381 *See* letter from NWC.

Many other commenters advocated that culpable whistleblowers should not be eligible for awards because the failure to exclude such whistleblowers would create significant incentives for individuals to engage in wrongdoing.[382] Some commenters stated that, if the final rule allows for awards to culpable whistleblowers, a whistleblower would have an incentive to conceal or fail to disclose a fraud as it continues to grow in order to satisfy the $1,000,000 threshold for award eligibility or to receive a larger award.[383] Others expressed concern that paying awards to culpable whistleblowers would harm internal compliance programs because it is critical that employees raise ethical and compliance concerns before a violation occurs and the proposed rules would incentivize whistleblowers to bypass or delay reporting violations internally.[384]

Other commenters recommended that the final rule should limit, but not prohibit, awards to culpable whistleblowers.[385] One commenter stated that the rules should allow the Commission to evaluate a person's culpable conduct and use that evaluation as a basis for reducing the amount of an award.[386] Several commenters stated that the role and culpability of the whistleblower in the unlawful conduct should be a required criterion that would result in reducing the amount of an award within the 10 to 30

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[382] *See, e.g.,* letters from SIFMA, Business Roundtable, Washington Legal Foundation, Morgan Lewis, Financial Services Roundtable, Society of Corporate Secretaries, Wells Fargo, Trace, Alcoa Group, Oppenheimer Funds, Association of Corporate Counsel, CCMC, Connolly & Finkel, Target, Thompson Hine, Americans for Limited Government, Ryder Systems, Verizon, AT&T, Institute for Corporate Ethics, TRACE International, Inc., and ABA.

[383] *See, e.g.,* letters from AT&T, Davis Polk, and John Wahh.

[384] *See, e.g.,* letters from the Business Roundtable and AT&T.

[385] *See, e.g.,* letters from Chris Barnard and Peter van Schaick.

[386] *See* the letter from ABA.

percent range.[387] Others suggested that a partial exclusion of culpable whistleblowers would be more appropriate. Specifically, these commenters recommended that whistleblowers' unlawful conduct should not be considered for determining the amount of a whistleblower award but should be considered when determining whether the $1,000,000 threshold has been met because the proposed rule disincentivizes individuals even marginally involved in the wrongful conduct from helping the Commission bring a successful enforcement action.[388]

c. Final Rule

We are adopting the proposed rule without modification, except that we are redesignating it as Rule 21F-16. After carefully considering the comments, we believe that the final rule appropriately incentivizes culpable whistleblowers to report securities violations while preventing culpable whistleblowers from financially benefiting from their own misconduct or misconduct for which they are substantially responsible.

As a preliminary matter, we do not believe that a *per se* exclusion for culpable whistleblowers is consistent with Section 21F of the Exchange Act. As commenters noted, the original federal whistleblower statute -- the False Claims Act -- was premised on the notion that one effective way to bring about justice is to use a rogue to catch a rogue.[389] This basic law enforcement principle is especially true for sophisticated

[387] *See, e.g.,* letters from the Auditing Standards Committee of the Auditing Section of the American Accounting Association, Wells Fargo, Chris Barnard and Peter van Schaick.

[388] *See, e.g.,* letters from DC Bar and Connolly & Finkel.

[389] *See* Cong. Globe, 37th Cong., 3d Sess. 955-56 (1863), *quoted in* Issues and Developments in Citizen Suits and Qui Tam Actions: Private Enforcement of Public Policy 119, 121 (1996) (U.S. Senator Jacob M. Howard—"I have based (the provisions of False Claims Act) on the old fashioned idea of holding out a temptation and 'setting a rogue to catch a rogue,' which is the safest and most expeditious way of bringing rogues to justice.").

securities fraud schemes which can be difficult for law enforcement authorities to detect and prosecute without insider information and assistance from participants in the scheme or their coconspirators. Insiders regularly provide law enforcement authorities with early and invaluable assistance in identifying the scope, participants, victims, and ill-gotten gains from these fraudulent schemes. Accordingly, culpable whistleblowers can enhance the Commission's ability to detect violations of the federal securities laws, increase the effectiveness and efficiency of the Commission's investigations, and provide important evidence for the Commission's enforcement actions.

Nevertheless, we share commenters' concern that failing to limit culpable whistleblowers' eligibility for awards could create incentives that are contrary to public policy. Accordingly, for purposes of determining whether the $1,000,000 threshold has been satisfied or calculating the amount of an award, the Commission will not count any monetary sanctions that the whistleblower is ordered to pay or that are ordered to be paid against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated.[390] This final rule provides an incentive for less culpable individuals to come forward and disclose illegal conduct involving others. At the same time, the rule limits awards based on the conduct attributable to the culpable whistleblower. The rationale for this limitation is that the common understanding of a whistleblower is one who reports misconduct <u>by another person</u> and it would be contrary to public policy for whistleblowers to benefit from their own

[390] In addition, as part of a negotiated settlement agreement, deferred prosecution agreement, non-prosecution agreement, immunity agreement, cooperation agreement, or other similar agreement with a highly culpable whistleblower, we have the ability to obtain the whistleblower's agreement to accept less than the statutory minimum or to forgo seeking a whistleblower award. We may exercise this authority in appropriate cases, including cases involving whistleblowers who seek to participate in the Commission's Cooperation Program and who substantially directed, planned, or initiated the violation.

misconduct. As for the suggestion that a partial exclusion for culpable whistleblowers should be adopted by the Commission, we believe that it would be inappropriate to treat culpable whistleblowers more favorably than other less or non-culpable whistleblowers, even if such differential treatment could result in additional submissions from culpable whistleblowers. Accordingly, we do not believe that the monetary sanctions of an entity associated with misconduct that the whistleblower substantially directed, planned, or initiated the reported misconduct should be considered when determining whether the culpable whistleblower met the $1,000,000 threshold. Finally, to minimize any incentive for whistleblowers to conceal misconduct or to delay reporting it, we have included in Rule 21F-6 a provision that requires the Commission to consider whether it would be appropriate to decrease a whistleblower's award percentage because of the culpability of the whistleblower or any substantial and unreasonable reporting delay by the whistleblower.[391]

P. <u>Rule 21F-17 - Staff Communications with Individuals Reporting Possible Securities Law Violations</u>

a. Proposed Rule

Proposed Rule 21F-16(a) provided that no person may take any action to impede a whistleblower from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement (other than agreements dealing with information covered by § 240.21F-

[391] We do not agree with the suggestion of some commenters that the rule will create an incentive for culpable whistleblowers to delay reporting in order to increase the potential for a larger award. Under these rules, a whistleblower has the greatest likelihood of receiving an award if he reports misconduct to us *first*. If a culpable whistleblower delays reporting, he runs the substantial risk that another person will report first, or that the misconduct will otherwise come to light, which will not only make the whistleblower unlikely to obtain an award, but will increase the likelihood that he will be prosecuted for his involvement in the misconduct.

4(b)(4)(i) & (ii) of this chapter related to the legal representation of a client) with respect to such communications. The Congressional purpose underlying Section 21F of the Exchange Act is to encourage whistleblowers to report possible violations of the securities laws by providing financial incentives, prohibiting employment-related retaliation, and providing various confidentiality guarantees.

Proposed Rule 21F-16(b) clarified the staff's authority to communicate directly with whistleblowers who are directors, officers, members, agents, or employees of an entity that has counsel, and who have initiated communication with the Commission related to a possible securities law violation. The proposed rule stated that the staff is authorized to communicate directly with these individuals without first seeking the consent of the entity's counsel. The objective of paragraph (b) is to implement several important policies inherent in Section 21F in a manner consistent with the state bar ethics rules governing the professional responsibilities of members of the staff who act in the capacity of attorneys.

Every jurisdiction that regulates the professional responsibility of lawyers has adopted some variation of ABA Model Rule 4.2, which provides: "In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order."[392]

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[392] MODEL RULES OF PROF'L CONDUCT R. 4.2. The primary purpose of ABA Model Rule 4.2 is to protect the attorney-client relationship and to protect represented persons, in the absence of their lawyers, from being taken advantage of by lawyers who are not representing their interests.

In the context of organizational entities represented by lawyers,[393] a difficulty in applying the various state versions of ABA Model Rule 4.2 is identifying those actors within the entity – such as directors or officers – that are the embodiment of the represented entity such that the proscription against contact applies.[394] This is so in part because the various state bar ethics rules have differing definitions of which organizational constituents are covered by Rule 4.2.[395]

As explained above, however, Section 21F of the Exchange Act evinces a Congressional purpose to facilitate the disclosure of information to the Commission relating to possible securities law violations and to preserve the confidentiality of those who do so.[396] This Congressional policy would be significantly impaired were the Commission required to seek the consent of an entity's counsel before speaking with a whistleblower who contacts us and who is a director, officer, member, agent, or employee of the entity. Similarly, whistleblowers falling within these categories could be less inclined to report possible securities law violations if they believed there was a risk

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393 *See generally Upjohn Co. v. United States*, 449 U.S. 383 (1981).

394 Comment 7 to ABA Model Rule 4.2 addresses this issue: In the case of a represented organization, this Rule prohibits communications with a constituent of the organization who supervises, directs or regularly consults with the organization's lawyer concerning the matter or has authority to obligate the organization with respect to the matter or whose act or omission in connection with the matter may be imputed to the organization for purposes of civil or criminal liability. Consent of the organization's lawyer is not required for communication with a former constituent. If a constituent of the organization is represented in the matter by his or her own counsel, the consent by that counsel to a communication will be sufficient for purposes of this Rule. Compare Rule 3.4(f). In communicating with a current or former constituent of an organization, a lawyer must not use methods of obtaining evidence that violate the legal rights of the organization.

395 Comment 5 to the ABA Model Rule 4.2 specifically carves out a potential exception for "investigative activities of lawyers representing governmental entities, directly or through investigative agents, prior to the commencement of criminal or civil enforcement proceedings." The commentary, and most state professional responsibility rules, do not specify which governmental investigative activities are exempt.

396 *See, e.g.*, Exchange Act Section 21F (b) through (d) and (h), 15 U.S.C 78u-6 (b) through (d) and (h).

that the Commission staff might be required to request consent of the entity's counsel – thus disclosing the whistleblower's identity -- before speaking to him or her.

For this reason, Section 21F necessarily authorizes the Commission to communicate directly with these individuals without first obtaining the consent of the entity's counsel. Paragraph (b) of the proposal would clarify this authority by providing that, in the context of whistleblower-initiated contacts with the Commission, all discussions with a director, officer, member, agent, or employee of an entity that has counsel are "authorized by law"[397] and, will therefore not require consent of the entity's counsel as might otherwise be required by rules of professional conduct.[398]

b. Comments Received

The comments that we received on Proposed Rule 21F-16(a) supported it. One commenter noted that the proposed rule is especially important because many firms require employees to sign confidentiality agreements.[399]

With respect to Proposed Rule 21F-16(b), a couple of commenters supported the proposal,[400] but others opposed it.[401] Those commenters opposing the proposal

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[397] As noted, ABA Model Rule 4.2 allows for contacts with represented persons without the consent of the person's lawyer if such contacts are "*authorized by law*." Every state bar ethics rules, in accordance with ABA Model Rule 4.2, has some variation of an authorized by law exception. Thus, in the context of communications initiated by a whistleblower who is also the director, officer, member, agent, or employee of an entity that has counsel, the proposed rule would make clear that contacts and communications between these individuals and the staff are "authorized by law."

[398] The proposed rule is not intended, and will not be used, to obtain otherwise privileged information about the entity. *See* SEC Division of Enforcement Manual § 3.3.1.

[399] *See* letter from POGO. *See also, e.g.*, letters from Kurt Schulzke (stating the proposed rule represents an improvement over the False Claims Act and IRS whistleblower regimes because of "(a) the effective nullification of confidentiality agreements and other actions to 'impede a whistleblower from communicating directly with the Commission staff about a potential securities law violation' and (b) the empowerment of the Commission staff to communicate directly with whistleblowers regardless of state bar ethics rules governing communications with represented parties."); VOICES (stating that a whistleblower should not be prevented from communicating directly with the Commission staff by actions such as enforcing, or threatening to enforce, a confidentiality agreement because such actions would "conflict with the purpose of the statute").

generally expressed concern that it could significantly erode the protections of the attorney-client privilege because the staff could seek to obtain attorney-client privileged information during the communications, or treat any attorney-client information that the whistleblower conveys as a waiver of the privilege. Several of these commenters recommended that the final rule should contain express language stating that the staff is not permitted to obtain attorney-client information during any communications authorized by the rule.[402]

Finally, a few comment letters asserted that the Commission lacks authority to establish an "authorized by law"[403] exception to state attorney ethics rule that would permit the staff to engage in these types of communications without the consent of the entity's counsel.[404] One of these commenters argued that nothing in Section 21F of the Exchange Act indicates that Congress intended to undermine the so-called McDade-Murtha Amendment, which requires attorneys at the Department of Justice to comply with the state bar disciplinary rules of the state in which they are licensed.[405]

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[400] *See, e.g.*, letters from NWC; Kurt Schulzke. *See also* Letter from Society of Corporate Secretaries (stating the Commission "does not 'need permission' to speak directly with a whistleblower," but should "be required to give the company notice that it intends to do so[.]").

[401] *See, e.g.*, letters from Business Roundtable; Financial Services Roundtable; GE Group; Alcoa Group; Association of Corporate Counsel; GE Group; Auditing Standards Committee.

[402] *See, e.g.*, letters from GE Group; Auditing Standards Committee; Business Roundtable.

[403] Model Rules of Professional Conduct, Rule 4.2.

[404] *See, e.g.*, letters from GE Group; Financial Services Roundtable; Association of Corporate Counsel.

[405] 28 U.S.C 530B.

c. Final Rule

After reviewing the comments, we are adopting Rule 21F-16 as proposed, except that we have redesignated it as Rule 21F-17.[406]

Rule 21F-17(a) is necessary and appropriate because, as we noted in the proposing release, efforts to impede an individual's direct communications with Commission staff about a possible securities law violation would conflict with the statutory purpose of encouraging individuals to report to the Commission.[407] Thus, an attempt to enforce a confidentiality agreement against an individual to prevent his or her communications with Commission staff about a possible securities law violation could inhibit those communications even when such an agreement would be legally unenforceable,[408] and would undermine the effectiveness of the countervailing incentives that Congress established to encourage individuals to disclose possible violations to the Commission.[409]

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[406] We have modified the rule text to make clear that it applies to any individual seeking to report possible securities law violations to the Commission, and not just those who provide information to us pursuant to the procedures set forth in Rule 21F-9(a).

[407] Based on the suggestion of a commenter, we wish to clarify that confidentiality agreements or protective orders entered in SRO arbitration or adjudicatory proceedings may *not* be used to prevent a party from reporting to us possible securities law violations that he or she discovers during the proceedings. *See* letter from Stuart D. Meissner, LLC. Indeed, given that the SRO's are charged with helping us enforce the federal securities laws, it would be an odd result if one party in an SRO proceeding could use a protective order to prevent another party from reporting a possible securities law violation to us.

[408] *See, e.g., In re JDS Uniphase Corp. Sec. Litig.*, 238 F.Supp.2d 1127, 1137 (N.D.Cal.2002) ("To the extent that [the confidentiality] agreements preclude former employees from assisting in investigations of wrongdoing that have nothing to do with trade secrets or other confidential business information, they conflict with public policy in favor of allowing even current employees to assist in securities fraud investigations."); *Chambers v. Capital Cities/ABC*, 159 F.R.D. 441, 444 (S.D.N.Y.1995) (holding that "it is against public policy for parties to agree not to reveal ... facts relating to alleged or potential violations of [federal] law").

[409] The proposed rule would not, however, address the effectiveness or enforceability of confidentiality agreements in situations other than communications with the Commission about potential securities law violations. Paragraph (a) of the proposal is not intended to prevent professional or religious

With respect to Rule 21F-17(b), we believe that this rule is a necessary and appropriate means to implement Section 21F's purposes of facilitating the disclosure of information to the Commission relating to possible securities law violations and preserving the confidentiality of those who do so.[410] As a result, our rulemaking authority under Section 21F(j) permits us to authorize our staff to communicate directly with directors, officers, members, agents, or employees of an entity that has counsel where the individual first initiates communication with the Commission as a whistleblower. Moreover, because Rule 21F-17(b) fits within the "authorized to do so by law" exception of ABA Model Rule 4.2 and the state bar rules modeled after it, Rule 21F-17(b) is fully consistent with state bar rules.[411]

Although a number of commenters expressed concern that this rule will undermine the attorney-client privilege, we emphasize that nothing about this rule authorizes the staff to depart from the Commission's existing procedures and practices when dealing with potential attorney-client privileged information.[412] As stated above,[413] compliance with the federal securities laws is promoted when individuals, corporate officers, and others consult about possible violations, and the attorney-client privilege

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organizations from responding to a breach of a recognized common-law or statutory privilege (*e.g.*, psychiatrist-patient, priest-penitent) by one its members.

[410] We have made one non-substantive clarifying change to the final rule text, replacing the term "subject of your communication" with "possible securities law violation." The final rule provides that "the staff is authorized to communicate directly with you regarding the possible securities law violation without seeking the consent of the entity's counsel."

[411] We disagree with the comment that Rule 21F-17(b) is inconsistent with the McDade-Murtha Amendment, 28 U.S.C. 530B. First, as we discussed above, Rule 21F-17(b) does not preempt state bar ethics rules, but instead is simply an application of the "authorized by law" exception. Second, McDade-Murtha does not apply to Commission attorneys.

[412] *See generally* SEC Division of Enforcement Manual § 4.

[413] *See supra* discussion of Rule 21F-4(b)(4)(i).

furthers such consultation. None of the rules that we are promulgating under Section 21F, *including* Rule 21F-17(b), is intended to undermine this benefit by having individuals disclose to us information about possible securities laws violations that they learned of through privileged communications. Thus, to the extent that the staff may be engaged in a communication authorized under Rule 21F-17(b) and issues relating to attorney-client privilege should develop, the staff will proceed in accordance with established Commission practices.[414]

## III. PAPERWORK REDUCTION ACT

Certain provisions of the Proposed Rules contained "collection of information" requirements within the meaning of the Paperwork Reduction Act ("PRA") of 1995.[415] An agency may not sponsor, conduct, or require a response to an information collection unless a currently valid Office of Management and Budget ("OMB") control number is displayed. The Commission submitted proposed collections of information to OMB for review in accordance with the PRA.[416] The titles for the collections of information were: (1) Form TCR (Tip, Complaint or Referral), (2) Form WB-DEC (Declaration Concerning Original Information Provided Pursuant to § 21F of the Securities Exchange Act of 1934), and (3) Form WB-APP (Application for Award for Original Information Provided Pursuant to § 21F of the Securities Exchange Act of 1934). These three forms were proposed to implement Section 21F of the Exchange Act. The proposed forms allowed

414 One commenter recommended that we should establish operating procedures to deal with potentially privileged material. *See* letter from Standards Committee of the Auditing Section of the American Accounting Association. The staff is in the process of developing internal operating protocols for dealing with attorney-client information that whistleblowers may provide us.

415 44 U.S.C. 3501 *et seq.*

416 44 U.S.C. 3507(d) and 5 CFR 1320.11.

a whistleblower to provide information to the Commission and its staff regarding (i) potential violations of the securities laws and (ii) the whistleblower's eligibility for and entitlement to an award.

The Commission did not receive any comments that directly addressed its Paperwork Reduction Act analysis or its burden estimates.[417] In comments on the rule proposals, a number of commenters suggested that the three-form process proposed for obtaining information from whistleblowers was burdensome.[418] As we discuss in connection with Rule 21F-9, our final Rules require largely the same information to be collected, but in response to comments we have combined the information collection into only two forms -- Form TCR, which incorporates several questions previously posed on Proposed Form WB-DEC, and Form WB-APP – to simplify the process for whistleblowers.

A. Summary of Collection of Information

Form TCR, submitted pursuant to Rule 21F-9, requests the following information:

1. Background information regarding each complainant submitting the TCR, including the person's name and contact information. We have added a section for the identification of additional complainants.
2. If the complainant is represented by an attorney, the name and contact information for the complainant's attorney (in cases of anonymous submissions the person must be represented by an attorney);

[417] We received one comment generally opining that our proposed rules failed to adequately account for the time expended by counsel in representing whistleblowers that extends beyond the completion of our proposed forms. *See* letter from Stuart D. Meissner, LLC at n. 3.

[418] *See. e.g.*, letters from Jane Liu; NWC; Patrick Burns.

3. Information regarding the person or entity that is the subject of the tip or complaint, including contact information;
4. Information regarding the tip or complaint, including the date of the alleged violation; the nature of the complaint; the type of security or investment, ticker symbol or CUSIP number and name of the issuer or security, if relevant; whether the complainant or counsel has had prior contact with Commission staff and with whom; whether information has been communicated to another agency and, if so, details about that communication, including the name and contact information for the point of contact at the agency, if available; whether the complaint relates to an entity of which the complainant is or was an officer, director, counsel, employee, consultant or contractor; whether the complainant has taken any prior actions regarding the complaint including reporting the violation to a supervisor, compliance office, whistleblower hotline, ombudsman, or any other available mechanism at the entity for reporting violations; and the date of such action was taken;
5. A description of the facts pertinent to the alleged violation, including an explanation of why the complainant believes the acts described constitute a violation of the federal securities laws;
6. A description of all supporting materials in the complainant's possession and the availability and location of any additional supporting materials not in the complainant's possession;

7. An explanation of how the person submitting the complaint obtained the information and, if any information was obtained form an attorney or in a communication where an attorney was present, the identification of any such information;
8. A description of any information obtained from a public source and a description of such source;
9. A description of any documents or other information in the complainant's submission that the complainant believes could reasonably be expected to reveal his or her identity, including an explanation of the basis for the complainant's belief that his or her identity would be revealed if the documents were disclosed to a third party; and
10. Any additional information the complainant believes may be relevant.

Also included in Form TCR are several items previously included in proposed Form WB-DEC, which was required to be submitted pursuant to Proposed Rule 21F-9. First, there are several questions that require a complainant to provide eligibility-related information, by checking a series of "yes/no" answers.[419] Second, the form contains a declaration, signed under penalty of perjury, that the information provided to the Commission pursuant to Proposed Rule 21F-9 is true, correct and complete to the best of the person's knowledge, information and belief. Third, there is a counsel certification, which is required to be executed in instances where a complainant makes an anonymous submission pursuant to the whistleblower program and thus must be represented by an attorney. This statement certifies that the attorney has verified the complainant's identity, and has reviewed the complainant's completed and signed Form

[419] *See supra* note 342 for a more detailed description of these questions.

TCR for completeness and accuracy, and that the information contained therein is true, correct and complete to the best of the attorney's knowledge, information and belief. The certification also contains new statements, which were not included in proposed Form WB-DEC, that: (i) the attorney has obtained the complainant's non-waivable consent to provide the Commission with the original completed and signed Form TCR in the event that the Commission requests it due to concerns that the form may contain false, fictitious or fraudulent statements or representations that were knowingly or willfully made by the complainant; and (ii) the attorney consents to be legally obligated to provide the signed Form TCR within seven (7) calendar days of receiving such request from the Commission.

Form WB-APP, submitted pursuant to Rules 21F-10 and F-11, requires the following information:

(1) The applicant's name, address and contact information;

(2) The applicant's social security number, if any;

(3) If the person is represented by an attorney, the name and contact information for the attorney (in cases of anonymous submissions the person must be represented by an attorney);

(4) Details concerning the tip or complaint, including (a) the manner in which the information was submitted to the SEC, (b) the subject of the tip, complaint or referral (TCR), (c) the TCR number, and (d) the date the TCR was submitted to the SEC;

(5) Information concerning the Notice of Covered Action to which the claim relates, including (i) the date of the Notice, (ii) the Notice number, and (iii) the case name and number;

(6) For related actions, (i) the name and contact information for the agency or organization to which the person provided the original information; (ii) the date the person provided this information, (ii) the date the agency or organization filed the related action, (iv) the case name and number of the related action, and (v) the name and contact information for the point of contact at the agency or organization, if known;

(7) A series of questions concerning the person's eligibility to receive an award as described in the discussion Form TCR above;[420]

(8) An optional explanation of the reasons that the person believes he is entitled to an award in connection with his submission of information to the Commission, or to another agency in a related action, including any additional information and supporting documents that may be relevant in light of the criteria for determining the amount of an award set forth in Rule 21F-6, and any supporting documents; and

(9) A declaration, signed under penalty of perjury, that the information provided in Form WB-APP is true, correct and complete to the best of the person's knowledge, information and belief.

B. Use of Information

The collection of information on Forms TCR and WB-APP will be used to permit the Commission and its staff to collect information from whistleblowers regarding

[420] *See supra* at 211 and note 342.

alleged violations of the federal securities laws and to determine claims for whistleblower awards.

C. Respondents

The likely respondents to Form TCR will be individuals who wish to provide information relating to possible violations of the federal securities laws and who wish to be eligible for whistleblower awards. The likely respondents to Form WB-APP will be individuals who have provided the Commission or to another agency in a related action with information relating to a possible violation of the federal securities laws and who believe they are entitled to an award.

D. Total Annual Reporting and Recordkeeping Burden

*i. Form TCR*

The Commission estimates that it will receive approximately 30,000 tips, complaints and referrals submissions each year through its Electronic Data Collection System or completed forms TCR.[421] Of those 30,000 submissions, the Commission estimates that it will receive approximately 3,000 Forms TCR each year.[422] Each respondent would submit only one Form TCR and would not have a recurring obligation. In the proposing release, we proposed that a whistleblower would have to complete two forms, proposed Form TCR and proposed Form WB-DEC, to be eligible for an award.

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[421] This number is a staff estimate based upon the volume of tips, complaints or referrals received by the Commission on a monthly basis during the past year. The staff believes that the volume of tips, complaints and referrals the Commission has received more recently, and particularly in the months since the passage of Dodd-Frank, provides a more accurate basis for estimating future volumes.

[422] This number is a staff estimate based upon the expectation that roughly 10 percent of all tips received by the Commission will be submitted in hard copy on Form TCR. The staff anticipates that most whistleblowers will elect to submit their information electronically. The electronic submission of information will provide whistleblowers with increased ease of use and will allow whistleblowers to submit more detailed information in roughly the same amount of time it would take them to complete a hard copy Form TCR. Moreover, the Commission should be able to use the information submitted electronically more effectively and efficiently. For example, the Commission will be able to conduct electronic searches of information without first having to convert the data into an electronic format.

In the Final Rules, we have eliminated Form WB-DEC and added the eligibility questions from that proposed form to Form TCR.

The Commission estimates that it will take a whistleblower, on average, one hour to complete the portion of Form TCR that does not include the questions that had previously been included in proposed Form WB-DEC. The completion time will depend largely on the complexity of the alleged violation and the amount of information the whistleblower possesses in support of the allegations. As a result, the Commission estimates that the annual PRA burden of Form TCR is 3,000 hours.

A person who submits information through a Form TCR or the Electronic Data Submission System and who wishes to be eligible for an award under the program must complete the remainder of Form TCR (the additional questions related to eligibility that had been included in Proposed Form WB-DEC). The Commission estimates that it will receive this additional information in roughly 50 percent of the cases in which the Commission receives a Form TCR or an electronic submission of information.[423] As noted above, the Commission estimates that it will receive approximately 30,000 combined electronic submissions and submission on Form TCR each year. Thus, the Commission estimates that it will receive responses to these additional questions in approximately 15,000 instances. We estimate that it will take a whistleblower, on average, 0.5 hours to complete the remainder of Form TCR.[424] Accordingly, we estimate that the annual PRA burden of the remainder of Form TCR is 7,500 hours.

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[423] This number is a staff estimate. Because this is a new program, the staff does not have prior relevant data on which it can base its estimate.

[424] This is consistent with our estimate of the time it would take a whistleblower, on average, to complete proposed Form WB-DEC.

*ii. Form WB-APP*

Each whistleblower who believes that he is entitled to an award because he provided original information to the Commission that led to successful enforcement of a covered judicial or administrative action, or a related action, is required to submit a Form WB-APP to be considered for an award. A whistleblower can only submit a Form WB-APP after there has been a "Notice of Covered Action" published on the Commission's website pursuant to Proposed Rule 21F-10. We originally estimated that we would post approximately 130 such Notices each year. Because the final rules allow for the aggregation of proceedings in certain circumstances, as described in Rule 21F-4(d), we have increased that estimate to 143 Notices per year.[425] In addition, we estimate that we will receive approximately 129 Forms WB-APP each year.[426] Finally, we estimate that it will take a whistleblower, on average, two hours to complete Form WB-APP. The completion time will depend largely on the complexity of the alleged violation and the amount of information the whistleblower possesses in support of his application for an award. As a result, the Commission estimates that the annual PRA burden of Form WB-APP is 258 hours.

[425] This number is a staff estimate based upon (i) the average number of actions during the past five years in which the Commission recovered monetary amounts, including penalties, disgorgement or prejudgment interest, in excess of $1,000,000; (ii) the assumption that there should be an increase (roughly 10 percent) in the number of such actions as a result of the aggregation of proceedings permitted under Rule 21F-4(d); and (iii) the assumption that there should be an additional increase (roughly 30 percent) in the number of such actions as a result of the whistleblower program.

[426] This number is a staff estimate based upon two expectations: first, that the Commission will receive Forms WB-APP in approximately 30 percent of cases in which it posts a Notice of Covered Action because we expect that we will continue to bring a substantial number of enforcement cases that are not based on whistleblower information; and second, that we will receive approximately 3 Forms WB-APP in each of those cases. Because this is a new program, the staff does not have prior relevant data on which it can base these estimates.

### *iii. Involvement and Cost of Attorneys*

Under the Proposed Rules, an anonymous whistleblower is required, and a whistleblower whose identity is known may elect, to retain counsel to represent the whistleblower in the whistleblower program. The Commission expects that, in most of those instances, the whistleblower's counsel will complete, or assist in the completion, of some or all of the required forms on behalf of the whistleblower. The Commission also expects that in the vast majority of cases in which a whistleblower is represented by counsel, the whistleblower will enter into a contingency fee arrangement with counsel, providing that counsel will be paid for the representation through a fixed percentage of any recovery by the whistleblower under the program. Thus, most whistleblowers will not incur any direct, quantifiable expenses for attorneys' fees for the completion of the required forms.

The Commission anticipates that a small number of whistleblowers (no more than five percent) will enter into hourly fee arrangements with counsel.[427] In those cases, a whistleblower will incur direct expenses for attorneys' fees for the completion of the required forms. To estimate those expenses, the Commission makes the following assumptions:

(i) The Commission will receive approximately 3,000 Forms TCR, 1,500 of which contain eligibility-related information previously contained in Proposed Form WB-DEC, and 129 Forms WB-APP annually;[428]

[427] This estimate is based, in part, on the Commission's belief that most whistleblowers likely will not retain counsel to assist them in preparing the forms.

[428] The bases for these assumed amounts are explained in Sections V.D.i., V.D.ii. and V.D.iii. above.

(ii) Whistleblowers will pay hourly fees to counsel for the submission of approximately 75 Forms TCR and 6 Forms WB-APP annually;[429]

(iii) Counsel retained by whistleblowers pursuant to an hourly fee arrangement will charge on average $400 per hour;[430] and

(iv) Counsel will bill on average: (i) 2.5 hours to complete a Form TCR[431],(ii), and (iii) 10 hours to complete a Form WB-APP.[432]

Based on those assumptions, the Commission estimates that each year whistleblowers will incur the following total amounts of attorneys' fees for completion of the whistleblower program forms: (i) $75,000 for the completion of Form TCR; (ii) $24,000 for the completion of Form WB-APP.

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[429] These amounts are based on the assumption, as noted above, that no more than 5 percent of all whistleblowers will be represented by counsel pursuant to an hourly fee arrangement. The estimate of the number of Forms TCR submitted by attorneys on behalf of whistleblowers may turn out to be high because it is likely that most attorneys will submit tips electronically, rather than use the hard-copy Form TCR. However, in the absence of any historical data to rely upon, the Commission assumes that attorneys will submit hard-copy Forms TCR in the same percentages as all whistleblowers.

[430] The Commission uses this hourly rate for estimating the billing rates of securities lawyers for purposes of other rules. Absent historical data for the Commission to rely upon in connection with the whistleblower program, the Commission believes that this billing rate estimate is appropriate, recognizing that some attorneys representing whistleblowers may not be securities lawyers and may charge different average hourly rates.

[431] In the proposing release, we estimated that it would take an attorney, on average, 2 hours to complete proposed Form TCR. As noted above, in the Final Rules, we have added to Form TCR questions regarding eligibility that had been in proposed Form WB-DEC. As a result, we estimate that it will take an attorney, on average, 2.5 hours to complete Form TCR.

[432] The Commission expects that counsel will likely charge a whistleblower for additional time required to gather from the whistleblower or other sources relevant information needed to complete Forms TCR and WB-APP. Accordingly, the Commission estimates that on average counsel will bill a whistleblower 2.5 hours for the completion of Form TCR and 10 hours for completion of Form WB-APP (even though the Commission estimates that a whistleblower will be able to complete the entire Form TCR (including the eligibility questions that had been found in Form WB-DEC) in 1.5 hours and Form WB-APP it two hours).

E. Mandatory Collection of Information

A whistleblower would be required to complete either a Form TCR or submit his or her information electronically and to complete Form WB-APP or submit his or her information electronically to qualify for a whistleblower award.

F. Confidentiality

As explained above, the statute provides that the Commission must maintain the confidentiality of the identity of each whistleblower, subject to certain exceptions. Section 21F(h)(2) states that, except as expressly provided:

- [T]he Commission and any officer or employee of the Commission shall not disclose any information, including information provided by a whistleblower to the Commission, which could reasonably be expected to reveal the identity of a whistleblower, except in accordance with the provisions of section 552a of title 5, United States Code, unless and until required to be disclosed to a defendant or respondent in connection with a public proceeding instituted by the Commission [or certain specific entities listed in paragraph (C) of Section 21F(h)(2)].

Section 21F(h)(2) also allows the Commission to share information received from whistleblowers with certain domestic and foreign regulatory and law enforcement agencies. However, the statute requires the domestic entities to maintain such information as confidential, and requires foreign entities to maintain such information in accordance with such assurances of confidentiality as the Commission deems appropriate.

In addition, Section 21F(d)(2) provides that a whistleblower may submit information to the Commission anonymously, so long as the whistleblower is represented by counsel. However, the statute also provides that a whistleblower must disclose his or her identity prior to receiving payment of an award.

## IV. ECONOMIC ANALYSIS

As discussed above, Section 21F of the Exchange Act (added by Section 922 of the Dodd-Frank Act) establishes substantial new incentives and protections for whistleblowers.[433] First, eligible whistleblowers are entitled to an award equal to 10 to 30 percent of the money recovered when they voluntarily provide us with original information that leads to a monetary sanction greater than $1 million in a Commission enforcement action. Second, Section 21F prohibits employment retaliation against individuals for making submissions to us and it provides that whistleblowers may make these submissions anonymously.

Although many of the requirements of the whistleblower award program are established by Section 21F, Congress authorized the Commission to issue rules and regulations as necessary or appropriate to implement the program. In doing so, we faced a number of policy issues on which we solicited public comment, including:

- Whether the whistleblower program should provide financial incentives for attorneys and others to breach the attorney-client privilege in order to seek an award?

[433] Whistleblowing is an individual decision that is generally guided by a complex mix of pecuniary elements (*e.g.*, fear of job loss) and non-pecuniary elements (*e.g.*, sense of "doing the right thing," fear of social ostracism). *See* Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 Boston Univ. L. Rev. 91, 112-13 (2007) (citing sources); *id.* ("Assuming rational decision making, an employee will blow the whistle when the marginal private benefits exceed the marginal private costs."). The whistleblower award program established by Section 21F seeks to shift the balance of these factors in favor of timely blowing the whistle over silence for individuals who may have useful, quality information about possible securities law violations.

- To what extent should the program provide awards to individuals who have violated the federal securities laws?
- Whether the program should require employees to first report possible violations through their employer's internal compliance procedures before coming to the Commission? If not, should the program provide other incentives to encourage employees to report internally in appropriate circumstances?

In order to implement the program effectively, we addressed these and other issues in our proposed rules, which defined and interpreted various statutory provisions, and established procedures that whistleblowers must follow both when submitting information to us and when applying for awards.

We requested comments and empirical data on all aspects of the economic analysis of the proposed rules, and received only a few comments specifically directed to that analysis. Two commenters recommended that we should consider the costs to companies and other entities that would result if employees are not required to report internally before coming to us.[434] Likewise, two commenters recommended that we should revise the rules to reduce the costs on companies and the Commission that may result from "false or spurious claims" or "meritless complaints" of possible securities law violations.[435] Although the commenter did not quantify these costs, it noted these costs

[434] *See* letters from the Association of Corporate Counsel and Edison Electric Institute. A number of other commenters also generally raised the concern that companies would be burdened if we did not require employees to report possible violations of the securities laws internally either before or simultaneously with the submission of information to the Commission. In our discussion of Rule 21F-4(c)(3) above, we discuss our views on this issue and our decision not to require whistleblowers to report internally.

[435] *See* letters from the ABA and Edison Electric Institute.

would include companies' legal and accounting fees, and the Commission's costs to review and evaluate these frivolous submissions.

Below we consider the costs and benefits of the final rules, and their effects on efficiency, competition, and capital formation. We limit our analysis to those rules on which we exercised discretion.

A. Analysis of Benefits, Costs, and Economic Effects of the Rules

In promulgating these rules, we have sought to strike the right balance in defining terms and otherwise implementing the whistleblower program so as not to be overly restrictive or overly broad. Overly restrictive definitions or requirements could render the program ineffective if this meant that only a small fraction of whistleblowers who provide us with significant information would qualify for monetary rewards. This could discourage potential whistleblowers from coming forward with information about possible securities law violations, thereby depriving us of meritorious tips. This could in turn mean that some securities law violations would continue unreported for longer periods of time, with the result that overall enforcement and deterrence of violations would be less effective.

By contrast, overly broad definitions and unduly permissive provisions could result in inefficient use of the Investor Protection Fund—especially in situations where the Commission is already well into the process of obtaining sufficient information to bring a successful enforcement action. An important effect of the whistleblower program is reduced economic cost of collecting necessary information about possible securities law violations. To achieve this, the rules should incentivize the prompt and early submission of high-quality, credible tips. From a cost-benefit perspective, doing so leverages the Investor Protection Fund to obtain the maximum benefit from the whistleblower program with respect to the twin goals of protecting investors and increasing public confidence in the markets.

In addition to these considerations, we also assessed the economic impact of our final rules on investors, companies, and other corporate entities. We particularly focused on how the whistleblower program could effectively and efficiently use internal compliance programs in appropriate circumstances to best achieve the statutory objectives, without imposing undue costs on whistleblowers, investors, our enforcement efforts, or companies. We recognized that various policy options presented different trade-offs with respect to the costs and benefits imposed on these various interests.

With these considerations in mind, and after reviewing the public comments we received, we have structured the definitions, interpretations, and other rule provisions to seek to (i) encourage high-quality submissions and discourage frivolous submissions, (ii) encourage whistleblowers to provide information early, rather than waiting to receive a request or inquiry from a relevant authority; (iii) minimize unnecessary burdens on whistleblowers and establish fair, transparent procedures; and (iv) promote the use of effective internal compliance programs in appropriate circumstances.

1. Eligibility for Anti-Retaliation Protection

Rule 21F-2(b) states that anti-retaliation employment protection will be provided to whistleblowers who have a "reasonable belief" that the information they provide reveals a possible securities law violation. The "reasonable belief" standard provides a familiar legal framework that puts potential whistleblowers on notice that meritless submissions cannot be the basis for anti-retaliation protection.

Reducing frivolous submissions in this way should provide benefits. First, Commission resources will be freed up to focus on more meritorious submissions. Second, the costs that employers can be forced to incur when employees abuse the anti-retaliation protections should be lower. These costs can include not only litigation costs resulting from bad faith claims of anti-retaliation, but also inefficiencies stemming from some employers' decisions not to take legitimate disciplinary action due to the threat of bad faith anti-retaliation litigation.

2. <u>The Penalty of Perjury</u>

Rule 21F-9(b) – which requires whistleblowers who wish to participate in the whistleblower program to declare, under penalty of perjury, that their submission is truthful to the best of their knowledge – should similarly discourage frivolous submissions. This should reduce the costs incurred by the Commission from devoting resources to review and evaluate frivolous submissions, and also create efficiency gains by permitting the Commission to place greater reliance on the accuracy of information that is received.[436] By reducing false and frivolous submissions, Rule 21F-9(b) should also reduce the costs to companies and other persons that might otherwise result from the Commission opening investigations based on false or spurious allegations of wrongdoing.

[436] *See, e.g.*, Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, J. FIN. (2011), *available at* http://www.afajof.org/afa/forthcoming/4820p.pdf.. The staff will review and evaluate all TCRs, regardless of whether the whistleblower has completed the declaration portion. However, because the declaration would aid in assessing reliability, the staff may consider whether a whistleblower has executed a declaration in prioritizing the investigation of TCRs and the allocation of the Division of Enforcement's limited resources. As Rule 21F-9 provides, a whistleblower will not be eligible for an award if he fails to complete the declaration at the time he submitted his TCR form.

### 3. Monetary Award Eligibility

Rule 21F-4 provides definitions for "voluntary" (*e.g.*, before the Commission issues a subpoena or makes a request)[437] and "information that leads to successful enforcement."[438] These definitions are designed to ensure that the Commission receives actionable whistleblower information – tips indicating a high likelihood of a substantial securities violation – in a timely manner. More specifically, the definitions seek to incentivize submissions involving information that is unobservable to the Commission, that is not likely to be uncovered as part of any on-going investigations or examinations, that increases the probability of a successful enforcement action, and that reduces our enforcement costs in terms of time, effort, and resources. We believe

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[437] Rule 21F-4(a) defines "Voluntary Submission of Information" to require that the whistleblower make his or her submission before a request, inquiry, or demand that relates to the subject matter of the submission is directed to the whistleblower or anyone representing the whistleblower (i) by the Commission; (ii) in connection with an investigation, inspection, or examination by the PCAOB or any self-regulatory organization; or (iii) in connection with an investigation by the Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority. The rule further provides that a whistleblower's submission will be deemed voluntary if it was provided after a Commission request, inquiry, or demand directed to the whistleblower, provided that the whistleblower had previously disclosed the information voluntarily to one of the other authorities identified in the rule. Finally, the rule provides that a submission is not voluntary if the whistleblower was required to report the information to the Commission as a result of a pre-existing legal duty, a contractual duty that is owed to the Commission or to one of the other authorities set forth in the rule, or a duty that arises out of a judicial or administrative order.

[438] Rule 21F-4(c) defines "Information that Leads to Successful Enforcement" such that a whistleblower is only entitled to an award if one of three general standards is satisfied. The first standard is met if a whistleblower gave the Commission original information that was sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of the whistleblower's original information. The second standard is met if the whistleblower gave the Commission original information about conduct that was already under examination or investigation by the Commission, or certain other specified law enforcement or regulatory entities, and the whistleblower's submission significantly contributed to the success of the action. Finally, the third standard permits a whistleblower to report original information through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time he reports the information to the Commission (but no later than 120 days after the internal submission); this standard under the led-to definition will be satisfied if the entity thereafter provided the whistleblower's information to us, or provided results of an audit or investigation initiated in response to the whistleblower's report, and the information the entity provided to us satisfies either (1) or (2) above.

that paying awards for whistleblower information that satisfies these criteria helps leverage the Investor Protection Fund to provide the maximum law enforcement benefit. By contrast, however, we do not believe that information provided by a whistleblower in instances where the Commission is about to obtain the same information in the ordinary course of an ongoing investigation would justify the expenditure of funds from the Investor Protection Fund, thus warranting the exclusion of such submissions from the definition of "voluntary" (so as to not qualify for an award). This will provide the additional benefit of incentivizing whistleblowers to report possible violations early – before they receive a subpoena or are otherwise requested to provide information by the Commission or other regulatory authority.[439]

The eligibility exclusions outlined in Rule 21F-4(b) under the definitions of "independent knowledge" and "independent analysis" are similarly sensitive to cost-benefit considerations. Rule 21F-4(b) excludes individuals in particular relations of trust from receiving awards in certain limited situations where, in our view, doing so on balance better promotes the overall enforcement of the federal securities laws. For example, we believe that we can achieve more efficient enforcement of the securities laws by not creating incentives for attorneys or others to breach the attorney-client privilege by submitting tips disclosing privileged communications. Attorneys are

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[439] We note that there may be an adverse incentive for would-be whistleblowers to delay blowing the whistle on a violation in progress in order to allow the magnitude of the harm to increase and thus qualify the potential whistleblower for a larger amount. *See, e.g.*, Robert Howse & Ronald J. Daniels, *Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy*, UNIV. PENN. SCHOLARLY COMMONS, Departmental Paper (1995) 527 ("[I]t is often suggested that the calibration of the amount of the reward from whistleblowing directly to the amount of the penalty . . . provides whistleblowers with an incentive to report wrongdoing later rather than earlier, and to do so only after the corruption has produced much more serious consequences, rather than disclosing evidence of corruption in the corporation immediately."). However, we believe that other elements of the whistleblower program provide additional incentives for whistleblowers to report information early. For example, a potential whistleblower who does not report information early runs the risk that another person may provide the same information to the Commission thereby possibly denying the dilatory whistleblower from receiving an award.

uniquely positioned to advise clients when conduct may violate the federal securities laws, and therefore they can plan a critical role in preventing or stopping such conduct. Accordingly, we believe that overall compliance with the federal securities laws is better promoted by generally excluding information that is shared in confidence with attorneys by their clients so as to promote open attorney-client consultations.

For similar reasons, we have placed certain limitations on the ability of particular categories of individuals to receive awards based on information that they learn in their professional capacity because of the positions that they occupy – *e.g.*, officers, directors, trustees, or partners of an entity; employees with internal audit or compliance responsibilities; and employees or associates of either firms that are retained to investigate possible securities law violations, or independent public accountants that are retained to conduct engagements required by the securities laws. As a general matter, these individuals occupy sensitive roles that can enable them to identify and stop possible violations of the securities law, and their diligence in doing so can be an important factor that companies or other entities achieve compliance. Thus, we believe it is a more efficient and cost-effective use of the Investor Protection Fund to provide further incentive to these individuals to fulfill those responsibilities rather than allowing them to use knowledge of possible wrongdoing to obtain an award by reporting to the Commission. That said, we have recognized certain exceptions to the exclusions that, in our view, reflect situations where the benefit of paying an award – in terms of reducing the harm to the entity and investors, and in preserving our enforcement capacity – justifies the cost associated with a claim on the Investor Protection Fund.[440]

Additionally, with respect to employees with internal audit or compliance responsibilities, we believe the exclusion is appropriate because to do otherwise would undermine the incentives for companies and other entities to establish and maintain effective internal compliance programs. As we discussed in more detail below in Part (A)(7), effective internal compliance programs can in appropriate circumstances provide significant benefits both in terms of reducing the harm that entities and investors experience from securities law violations, and in terms of efficiently assisting our own enforcement efforts.

Finally, Rule 21F-4(d) interprets the statutory term "action" to allow the Commission to aggregate the monetary sanction from two or more closely associated judicial or administrative proceedings.[441] From a cost perspective, this will result in more awards, as well as larger awards, being paid from the Securities Investor Protection Fund. However, we believe the benefits of these additional award expenditures justify those costs. The ability to aggregate the monetary sanctions from

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[440] These exceptions, which are set forth in Rule 21F-4(b)(4)(v), permit a submission where: (i) a report to the Commission is necessary to prevent substantial harm to the entity or investors; (ii) the entity is engaging in conduct that will impede our investigation; or (iii) 120 days have elapsed.

[441] Rule 21F4(d) defines a Commission "action" generally as a single captioned judicial or administrative proceeding brought by the Commission. However, the rule identifies two exceptions to this general definition to allow payment of an award in cases where we may have chosen for various reasons to bring separate proceedings against respondents or defendants involved in the same or closely related conduct. The first exception to the general definition provides that an action will constitute two or more Commission proceedings arising from the same nucleus of operative facts for purposes of making an award under Rule 21F-10; this will permit, for example, considering two or more proceedings together to determine that there are monetary sanctions in excess of $1,000,000 and that an award may be paid. The second exception provides that, for purposes of making payments under Rule 21F-14 on a Commission action for which we have already made an award, we will treat as part of the same action any subsequent Commission proceeding that, individually, results in a monetary sanction of $1,000,000 or less, and that arises out of the same nucleus of operative facts.

two or more closely associated Commission proceedings should enhance the incentive for whistleblowers to come forward in a timely manner where there is the potential for multiple closely-associated Commission proceedings that collectively may reflect more than a million dollars in monetary sanctions, but none of which would likely do so individually. Without the ability to aggregate Commission proceedings in these instances, a potential whistleblower might prefer to delay reporting possible violations until he is sufficiently confident that the Commission can bring at least one single proceeding that satisfies the covered action threshold; this could lead to unnecessary additional costs for entities and investors due to the delay in reporting on-going violations.

4. Eligibility for culpable whistleblowers

Rule 21F-16 is designed to minimize the potential costs and enhance the benefits of paying a culpable whistleblower an award.[442] On the one hand, we do not believe the Investor Protection Fund should pay culpable whistleblowers for their own misconduct or with respect to highly culpable whistleblowers, to also pay for the misconduct of entities that they directly cause. On the other hand, we also recognize that culpable whistleblowers can be a valuable source of information about undetected securities law violations. Thus, we believe the Investor Protection Fund should pay culpable whistleblowers for information that leads to monetary sanctions against other participants in the violation; indeed, to do otherwise could unduly reduce the amount of

[442] Rule 21F-16 provides that, in determining whether the required $1 million threshold for an award has been satisfied, the Commission will not include any monetary sanctions (i) that the whistleblower is ordered to pay, or (ii) that an entity is ordered to pay if the entity's liability is based substantially on conduct that the whistleblower directed, planned, or initiated. The rule also provides that the Commission will not include any such amounts in the total monetary sanctions collected for purposes of calculating the amount of an award payment to a whistleblower.

useful information the Commission receives, thereby resulting in some on-going violations remaining undetected to the detriment of investors.

5. Award Amount Factor

The revisions to final Rule 21F-6, governing the criteria used in determining the amount of an award, are designed to provide strong incentives for the whistleblower to report violations with increasing levels of quality, timeliness, and validity.[443] Rule 21F-6 allows the Commission to set the award percentage based, among other things, on the significance of the information provided by the whistleblower and any unreasonable delay by the whistleblower in making the submission.[444] Taken together, these rules provide for greater awards for more timely and more useful information, and reduced awards for whistleblowers whose dilatory or uncooperative conduct may impair our enforcement efforts.

The rules also encourage whistleblowers to work with the Commission as we investigate and litigate enforcement actions, which should provide the benefit of enhanced Commission enforcement of the federal securities. For example, Rule 21F-6(a)(2) provides that, in setting the award percentage, we will consider the assistance the whistleblower provided us. To complement this, Rule 21F-17(a) makes it unlawful

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[443] Rule 21F-6 sets forth the factors for determining the award percentage. Four general factors may lead to an increase in the award percentage: the significance of the information provided by the whistleblower; the assistance provided by the whistleblower; the law enforcement and programmatic interests; and the whistleblower's voluntary participation in internal compliance systems. In addition, three general factors may lead to a decrease in the award percentage: the whistleblower's culpability or involvement in the matters associated with the Commission or related action; a substantial and unreasonable reporting delay; or, in cases where the whistleblower, while interacting with his entity's internal compliance or reporting system, interferes with or otherwise undermines the system's integrity.

[444] *See* Ben Depoorter & Jef De Mot, *Whistleblowing: An Economic Analysis of the False Claims Act*, 14 Sup. Ct. Econ. Rev. 135, 158 2006 (awards should be structured to align whistleblowers private incentives with the public interest in timely reporting).

for another person to take action that impedes a whistleblower's efforts to communicate with the Commission. Likewise, Rule 21F-17(b), by authorizing communications between the Commission staff and a whistleblower without seeking consent of the counsel of an entity with whom the whistleblower is employed, has the benefit of encouraging whistleblowers to communicate with us without the fear that their communications will lead to disclosure of their identity to their employer.[445] We believe that these rules provide benefits by ensuring that whistleblowers are able to work with the Commission as it takes actions in response to possible securities law violations, and thus justify any costs on companies.

6. Procedures Required for a Whistleblower to Qualify for an Award

The procedural rules adopted also further the effective implementation of the program.[446] Form WB-APP requires the submission of information that is necessary for the Commission to determine award eligibility. The Commission recognizes that it will take time and effort on the part of whistleblowers to complete and submit the forms. While requiring an additional form imposes a cost on potential whistleblowers, determining the appropriate level of award for each instance of qualified whistleblower is critical to successful implementation of the whistleblower rule. The Commission needs

[445] Rule 21F-17(b) states that if a whistleblower who is a director, officer, member, agent, or employee of an entity that has counsel has initiated communications with the Commission relating to a possible securities law violation, the staff is authorized to communicate directly with the whistleblower regarding the subject of the communication without seeking the consent of the entity's counsel.

[446] Rules 21F-9, 10 and 11 set forth the procedures for submitting information and making a claim for an award. First, Rule 21F-9(a) provides that an individual qualifies as a whistleblower if he submits a Form TCR electronically through the Commission's web page or provides the Commission with a completed copy by mail or facsimile. Second, Rule 21F-9(b) provides that, to qualify for an award, the whistleblower must declare under penalty of perjury that the information in the Form TCR is true, correct, and complete to the best of his knowledge, information, and belief. The rules also require potential whistleblowers to complete a second form in the claims phase to establish potential eligibility for an award under the program. Pursuant to Rules 21F-10 and 21F-11, a whistleblower must complete Form WB-APP to apply for an award for a covered judicial or administrative action by the Commission or a related action.

to collect pertinent information from the whistleblower to determine whether he or she should receive an award and, if so, in what amount. This information will need to be evaluated in conjunction with the Commission's enforcement action to determine the significance of the whistleblower's contribution. While we have simplified the procedures in the final rules, it is still possible that some prospective whistleblowers could find the procedures burdensome, and as a result, be deterred from coming forward to provide information to the Commission.

The procedural elements in the rules are structured to provide a fair, transparent process for consideration of whistleblower award claims. We believe that this should help incentivize individuals to participate in the whistleblower award program by coming forward with high-quality, timely information about possible securities law violations.

There is also an additional cost on whistleblowers who wish to participate anonymously in the whistleblower program – Rule 21F-9(c) requires that these whistleblowers locate and retain counsel to make a submission on their behalf.[447] We recognize that this requirement may, in some instances, discourage potential whistleblowers from making submissions of valuable information. Nonetheless, we believe that on balance this requirement is appropriate. For example, the attorney is needed to serve as the point-of-contact for us when we need to elicit additional information, while at the same time continuing to preserve the confidentiality of the whistleblower. The involvement of an attorney can also help to protect against the possibility that anonymous whistleblowers are making frivolous or false submissions, can help the whistleblower develop and draft his submission to maximize its

[447] The statute requires that a whistleblower who makes an anonymous claim for an award must be represented by counsel. Section 21F(d)(2)(A) of the Exchange Act.

informational value to the Commission (and thus the whistleblower's chance of an eventual award), and can assist in verifying the whistleblower's eligibility for participation in the program early in the process.

The 120-day "look back" period for whistleblowers who make submissions internally may also impose costs on whistleblowers in that it requires them to act within a certain period of time to ensure that their eligibility for an award under the program is not compromised. The Commission has set the 120-day period based on a consideration of those costs against the concern that a longer grace period could serve to delay the Commission's receipt of valuable information that could be used to protect investors.[448]

7. Incentives for Internal Reporting

As discussed above, we have built significant incentives into the whistleblower award program that we believe will encourage whistleblowers to report internally in appropriate circumstances. We believe that this approach effectuates the general statutory purpose of Section 21F of the Exchange Act – which is to enhance the enforcement of the federal securities laws by encouraging whistleblowers to come forward to the Commission[449] with quality tips regarding possible securities law violations – in a manner that is consistent with, and reflective of, cost-benefit considerations.

[448] As stated in the release discussion of Rule 21F-4(b)(7), this 120-day period applies only to whistleblowers and does not prescribe for companies the appropriate time limits for reporting violations to the Commission, nor does it impose an obligation to report.

[449] *See* S. Rep. No. 111-176 at 110 (2010) ("The Whistleblower Program aims to motivate those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated the securities laws ....").

Our proposed rules solicited comment on the question of how, if at all, to incorporate internal compliance reporting into the whistleblower award program. The focus of the proposed rules was on the principal purpose of the statute, which is ensuring that the Commission receives quality tips as a result of the financial incentive created by Section 21F of the Exchange Act.[450]

In response to the proposed rules, many commenters from the corporate community argued that whistleblowers would divert from internal reporting in response to the financial incentive of a potential whistleblower award from the Commission.[451] These commenters further argued that companies and other entities would experience significant costs as a result. Among the costs that they identified are the following: (i) increased harm to entities and investors due to the delay in entities learning about on-going violations from the Commission rather than from internal whistleblowing; (ii) increased defense and litigation costs in responding to Commission enforcement proceedings from, among other things, non-meritorious whistleblower complaints that could have been resolved internally; (iii) increased harm to entities and investors when *non*-securities law violations go unreported to the entity. These commenters did not provide us with projections or estimations regarding either the degree to which

[450] Our proposing release did explain, however that whistleblower reporting through internal compliance procedures can complement or otherwise appreciably enhance our enforcement efforts in appropriate circumstances. For instance, the subject company may at times be better able to distinguish between meritorious and frivolous claims, and may make such findings available for the Commission. This would be particularly true in instances where the reported matter entails a high level of institutional or company-specific knowledge and/or the company has a well-functioning internal compliance program in place. Screening allegations through internal compliance programs may limit false and frivolous claims, provide the entity an opportunity to resolve the violation and report the result to the Commission, and allow the Commission to use its resources more efficiently.

[451] *See, e.g.*, letters from CAQ, Edison and GE Group. *See also* letter from the CCMC ("In the absence of an affirmative restriction on external reporting when effective internal compliance channels are available, or provision of significant incentive for using those internal channels, employees will face an irresistible temptation to go to the SEC with their report.").

whistleblowers would likely be diverted from internal reporting under our proposed rule, or the resulting costs to companies or other entities.[452]

Analysis of the academic literature, although not wholly conclusive, provides reason to believe that a sizable percentage of whistleblowers who currently report internally are motivated by non-monetary reasons.[453] Thus, we anticipate that many whistleblowers would continue to report internally.

Nonetheless, we recognize that there could be a sizeable percentage of whistleblowers who, under our rules, could now be more motivated to report to the

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[452] We do note, however, that other commenters provided some evidence to counter the assertion that whistleblowers would be diverted from reporting internally in significant numbers. For example, one commenter cited an empirical study of the False Claims Act (FCA)—which requires no mandatory internal reporting—stating that "the overwhelming majority of employees voluntarily utilize internal reporting processes, despite the fact that they were potentially eligible for a large reward under the FCA." Letter from NWC at 4. This study claims that "89.7 percent of employees who eventually filed False Claims Act cases had made an internal report, despite the absence of a legal requirement that they do so." *See supra* discussion in footnote 232. *See also* letter from TAF at 22 ("[I]t is our membership's experience that the vast majority of whistleblowers *do*, in fact, report their concerns first to either their superiors or compliance officers, and only avail themselves of statutory whistleblower programs when their concerns have been dismissed or unaddressed, or when they suffer retaliation.") (emphasis in original). *See generally* Aaron S. Kesselheim et al., *Whistle-Blowers' Experiences in Fraud Litigation Against Pharmaceutical Companies*, 362 NEW ENGLAND J. MED. 1832, 1834 & 1836 (2010) (a study of *qui tam* cases involving pharmaceutical companies that showed "[n]early all (18 of 22) insiders first tried to fix matters internally by talking to their superiors, filing an internal complaint, or both" despite the fact that the ultimate monetary awards from external reporting were large, ranging from $100,000 to $42 million, with a median of $3 million."); *id.* at 1839 (discussing possible limitations with the study).

[453] Whistleblowers are often willing to report notwithstanding the absence of financial incentives and the potential for costs to them in terms of time, money, social stigma, and a possible job loss. Non-monetary incentives that often motivate individuals to whistleblow include: (i) cleansing the conscience, (ii) punishing wrongdoers (in some cases out of spite), (iii) simply "doing the right thing" for the sake of a general increase in social welfare, or (iv) motive for self-preservation. *See* Anthony Heyes & Sandeep Kapur, *An Economic Model of Whistleblower Policy*, 25 J. L. ECON. & ORG. 157, 159 (2009) (providing a short review of academic literature on sociology and psychology and listing non-monetary motives for whistleblowing); *see also* Aaron S. Kesselheim et al., *Whistle-Blower's Experience in Fraud Litigation Against Pharmaceutical Companies*, 362 NEW ENGLAND J. MED. 1832, 1834 (2010) (listing as primary motivations for *qui tam* lawsuit self-preservation, justice, integrity, altruism or public safety) (cited by letter from NWC). Research has also shown that the likelihood of internal whistleblowing increases when ethical and legal compliance policies exist in an organization, particularly if specific whistleblowing procedures are in place. Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. L. REV. 1107, 1142-43 (2006) ("A disclosure channel also harmonizes with a whistleblower's tendency to report misconduct internally—by this sense of loyalty. ... [Internal reporting] fits well with the psyche of the American employee, whose sense of loyalty to the organization keeps her from reporting misconduct externally, but who may report internally if encouraged by the organization.") (cited in letter from CCMC).

Commission in lieu of reporting internally because of the financial incentives created by the whistleblower program. In response to this possibility, we have tailored the final rules to provide whistleblowers who are otherwise pre-disposed to report internally, but who may also be affected by financial incentives, with additional economic incentives to continue to report internally. The final rules provide that a whistleblower who reports internally can collect a whistleblower award from the Commission if his internal report to the company or entity results in a successful covered action. In addition, the final rules provide that when determining the amount of an award, the Commission will consider as a plus-factor the whistleblower's participation in an entity's internal compliance procedures.

We believe these provisions should substantially reduce the degree of diversion of whistleblower reporting from companies. Assuming that some significant percentage of whistleblowers who were pre-disposed to report internally prior to the whistleblower program are inclined to change their behavior in response to financial incentives, these provisions should mitigate any diversion effect. These provisions do so by providing that an internal report can be an additional path to a whistleblower award. Indeed, to the extent that this sub-set of potential whistleblowers is responsive to economic incentives, they should be motivated to report internally by the final rules because by doing so they can increase both the probability and the magnitude of a potential recovery. Specifically, if they submit their tip internally, and either simultaneously or within 120 days make the same submission to the Commission, it is conceivable that they can increase the probability of an award because they now have two paths to a recovery – a Commission investigation, or an internal corporate investigation. They can increase the magnitude of a potential award because of the award criteria that provides a plus-factor for participation in an entity's internal compliance procedures.[454]

These additional financial incentives for whistleblowers to report internally should make it less likely that significant numbers of tips will be diverted from internal reporting.[455] This in turn should mitigate companies' costs from lost internal whistleblower reports. Moreover, while some whistleblower tips may nonetheless be diverted to the Commission,[456] any decrease in internal reporting should be offset at least in part by the fact that our final rules will incentivize other individuals who might not have reported internally prior to the whistleblower program to do so now. The financial incentives offered by the final rules to report internally should induce individuals to

[454] We believe that the final rules' financial incentives to report internally should be particularly attractive to whistleblowers who may be uncertain that their information is sufficiently compelling to cause the Commission staff to open an investigation. Where this is the case, whistleblowers may reasonably view internal compliance as the more likely path for an eventual award on the belief that an effective internal compliance process will investigate the information.

[455] A commenter suggested that some whistleblowers could still decline to report a violation internally based on the strategic calculation that the company could reduce the monetary sanctions through remediation, self-reporting, cooperation, etc., which in turn might reduce the whistleblower's award. *See* letter from CCMC. Although the commenter provided neither anecdotal nor empirical evidence to support this proposition, we think the incidence of this (if it should occur) would be relatively small for several reasons. *Cf.* letter from NWC at 7. First, no whistleblower can safely assume that his decision to bypass internal compliance will in fact lead to larger monetary sanctions. We will make our own assessment of the circumstances – indeed, as noted at pp. 92, sometimes our first step will be to contact the company – and good cooperation by the company overall, even in response to contact from the Commission staff, might mean that the monetary sanctions will not be any greater than if the whistleblower had simultaneously reported internally. Second, various factors in Rule 21F-6 allow us to account for a reduced monetary sanction by providing for an upward adjustment in the award determination where the internal reporting potentially resulted in a lower monetary sanction. Finally, to the extent there is any impact on whistleblower behavior, we believe it will generally mean that whistleblowers decide to report simultaneously, rather than availing themselves of the 120-day look-back period, out of concern that the latter course might afford companies an increased opportunity to take actions that could possibly result in a reduced monetary sanction.

[456] For example, we recognize that, notwithstanding the strong financial incentives to report internally, whistleblowers may bypass internal compliance procedures in cases involving clear fraud or other instances of serious securities law violations by senior management. In these cases, however, we believe the benefits of coming to the Commission, both in terms of our enforcement efforts and in terms of investors' interests, will often be quite significant, so as to justify any potential costs to the entity.

report who, absent any financial incentive, would never have reported either internally or to the Commission.[457] As a result, companies and other entities should now receive some information related to possible violations that they would not have otherwise received, which in turn may allow these entities to stop on-going violations, thereby limiting the harm to the entities and investors sooner than might otherwise have been the case.

In addition to considering the benefits and costs of the final rules on companies and other entities, we considered the benefits and costs of the final rules on our own enforcement program. As we stated in our proposing release, internal reporting to effective compliance programs can provide valuable assistance to our own enforcement efforts. By providing a strong financial incentive for whistleblower to report internally when appropriate, we are leveraging the Investor Protection Fund established by Section 21F of the Exchange Act to obtain the benefit of effective internal compliance programs that can respond to whistleblower tips by, among other things, undertaking prompt investigations that can lead to timely, well-documented reports of violations to the Commission.

As alternatives to the significant incentives approach that we have adopted, we considered the suggestions from commenters that we adopt some form of a mandatory internal reporting requirement as a condition on whistleblowers for award eligibility. Such an approach could take the following forms: (1) mandatory internal pre-reporting,

[457] *See* Elletta Sanrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 Vill. L. Rev. 273, 284 (finding that "money rewards for whistleblowing may produce the desired result of increasing the number of individuals willing to report activity" and stating that "financial incentives should encourage a new type of whistleblower to step forward"). *See generally* Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 Boston Univ. L. Rev. 91, 118-26 (2007) (discussing reasons that insiders may not report information about ongoing corporate and financial fraud in the absence of significant financial incentives to do so).

where the whistleblower's eligibility would be conditioned on his first making a report internally and providing the company's internal compliance function a meaningful period of time to respond; or (2) mandatory simultaneous reporting, under which the whistleblower's eligibility is conditioned upon a simultaneous report to internal compliance and the Commission. We evaluated these alternatives by analyzing how whistleblowers' expected behavior might change relative to the significant incentives approach adopted in the final rules, and what those changes might mean for the resulting costs and benefits to companies as well as the Commission's enforcement efforts.

We believe that either a mandatory pre-reporting or a simultaneous reporting requirement would not achieve an appreciable cost-benefit advantage over the approach we are adopting, and indeed a mandatory internal reporting requirement could be less advantageous because it could result in less overall whistleblowing. With respect to those whistleblowers who are already pre-disposed to report internally, a mandatory internal reporting requirement should have little or no net difference from the significant financial incentives approach that we are adopting.[458] To the extent that these whistleblowers respond to the financial incentives of a potential whistleblower award, we would expect them to report internally under a mandatory internal reporting requirement to be eligible for a whistleblower award from us, or to report internally under

[458] Some commenters suggested that a mandatory internal pre-reporting requirement could reduce the Commission's cost of information processing by filtering out frivolous or low quality tips from being submitted to us. *See* Americans for Limited Government. However, we believe other mechanisms in the final rules are reasonably designed to discourage frivolous submissions and thus reduce the attendant costs. *See supra* discussion in Parts IV.A (1)-(2).

our final rules so as to seek to increase the probability and magnitude of any potential award.

The most likely difference between a mandatory regime and the significant financial incentives approach is with respect to the category of whistleblowers who, prior to the whistleblower award program, were not predisposed to report either internally or to the Commission, but who are now willing to come forward in response to a financial inducement. Within this category of whistleblowers, we believe there is some subset who would respond to the financial incentive offered by our final rules by reporting only to us, but who would not come forward either to us or to the entity if the financial incentive were coupled with a mandatory internal reporting requirement.[459] Requiring internal reporting would have several adverse consequences: the Commission would lose critical information about some possible securities law violations, and companies and investors in turn would suffer as on-going violations remained undetected and unremedied.[460]

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[459] We believe that the fear of retaliation and other forms of harassment, as well as other social and psychological factors, can have a chilling effect on certain whistleblowers who, absent a mandatory internal reporting requirement, would respond to the financial incentive offered by the whistleblower program by providing the Commission with information about possible securities law violations. A number of commenters who have experience dealing with whistleblowers support this assessment. *See*, e.g., letters from TAF at 21-23 (Dec. 17, 2010); POGO at 4-5 (Dec. 17, 2010); Grohovsky Group at 4 (Dec. 16, 2010). Our review of the academic literature further supports this assessment. *See generally* Luigi Zingales, *Want to Stop Corporate Fraud? Pay Off Those Whistle-Blowers*, AEI-BROOKINGS JOINT CENTER POLICY MATTERS (January 18, 2004); Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 BOSTON UNIV. L. REV. 91; Pamela H. Bucy, *Information as a Commodity in the Regulatory World*, 39 HOUS. L. REV. 905, 948-959; Aaron S. Kesselheim et al., *Whistle-Blowers' Experiences in Fraud Litigation Against Pharmaceutical Companies*, 362 NEW ENGLAND J. MED. 1832, 1834 (2010); *see also* Letter from Eric Dixon LLC (Dec. 19, 2010) ("[W]histleblowers expose them[selves] to serious risk, including harm to them and their families, professional or career reprisals and community ostracization. Whistleblowers may also face retaliation from alleged wrongdoers or their associates, including civil suits").

[460] There are additional costs that could follow from a mandatory internal pre-reporting requirement where the company or entity's internal compliance process is ineffective and thus unlikely to respond properly to the violation. In these situations, the mandatory internal pre-reporting requirement would result in delays before the violation can be addressed by the Commission, resulting in potentially

Finally, we have considered the alternative of mandating that a whistleblower report internally within a specified period of time after reporting to us, unless upon reviewing the submission we direct the whistleblower not to report internally. Conceptually, this approach could allow the Commission an opportunity to review a whistleblower's submission and direct him not to report internally in situations where, among other things, (i) we identify a basis to believe that he might in fact suffer retaliation, or (ii) there would be no benefit to reporting internally either because the entity might engage in a cover-up or the internal compliance program is ineffective. This approach could encourage some whistleblowers who might otherwise be discouraged from reporting to us under a pure mandatory reporting regime because these whistleblowers could perceive an opportunity to persuade the Commission that they should be excused from making the mandatory internal report.[461]

Notwithstanding this potential benefit, however, we do not believe that this approach would have any significant cost-benefit advantage over the approach that we have adopted. In fact, this alternative approach would have significant disadvantages over the adopted rules. Simply put, for this approach to operate effectively and efficiently, the Commission would need to be in a position to meaningfully assess within a very short time – likely a few weeks – whether a whistleblower should be excused

increased injuries to the company and investors. *See* letter from CCMC at 6 ("Of course, when internal reporting systems are nonexistent or illusory, it is appropriate and beneficial for employees to report information of wrongdoing directly to the SEC."). In other cases, mandatory internal reporting could result in spoliation or other interference with our ability to investigate.

[461] We believe that many whistleblowers would still elect not to participate in the whistleblower program because of the uncertainty ahead of time regarding whether we would tell them not to report internally. As a result, we believe that it remains the case even under this approach that many whistleblowers would not report possible securities law violations to us due to the internal reporting requirement, and thus ongoing violations would continue undetected resulting in further harms to entities and investors.

from reporting internally. However, the Commission is not in a position to make the necessary fact-intensive assessments identified above in a considered and reliable manner, especially within this short time frame.[462] Moreover, this could divert limited resources from the primary objective of investigating allegations of wrongdoing.

As stated earlier, Congress did not include an internal reporting requirement in the statute, which is modeled upon the DOJ and IRS whistleblower program.[463] Instead, Congress enacted a requirement that provides financial incentives and employment retaliation protections for reporting directly to the Commission. Internal compliance programs are valuable, and under appropriate circumstances, these rules provide financial encouragement for whistleblowers to utilize those programs. At the same time, however, internal compliance programs cannot serve as adequate substitutes for our obligation to identify and remedy violations of the federal securities laws. In addition, there are circumstances where whistleblowers may have legitimate reasons for not wanting to report information internally, even if the company provides an avenue for anonymous reporting. For these reasons, the adopted approach encourages the whistleblower to report allegations internally, yet ultimately and appropriately leaves that decision to the whistleblower.

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[462] In contrast to any of the alternative mandatory reporting regimes, we believe that the financial incentives approach has the additional advantage that it allows whistleblowers to select the proper reporting procedures under the specific circumstances. Whistleblowers can balance the potential increase in the probability and magnitude of an award by participating in an effective internal compliance mechanism, against the particular risks that may result from doing so, which could include retaliation, loss of anonymity (for those companies that may not have effective anonymous reporting procedures), delay due to an ineffective or questionable internal compliance mechanism, and destruction of evidence based on the nature of the allegations or the corporate environment. On balance, we believe that, from a law-enforcement perspective, overall efficiency is better promoted by allowing whistleblowers to make this assessment on a case-by-case basis.

[463] *See* S. Rep. No. 111-176 at 111 (2010).

## B. Additional Considerations of Competition, Efficiency, and Capital Formation

Section 23(a)(2)[464] of the Securities Exchange Act of 1934 requires the Commission, in promulgating rules under the Exchange Act, to consider the impact that any rule may have on competition and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Further, Section 3(f) of the Exchange Act[465] requires the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

We expect that the impact of the final rules on capital formation and efficiency will be generally positive. As discussed above, the final rules are structured to encourage the submission of more actionable information both to the Commission and to internal compliance programs regarding possible securities law violations. This will have several positive effects on capital formation. First, to the extent that more effective enforcement leads to earlier detection of violations and increased deterrence of potential future violations, this should assist in a more efficient allocation of investment funds. Serious securities frauds, for example, can cause inefficiencies in the economy by diverting investment funds from more legitimate, productive uses. Second, the deterrent effect of our rules should result in a higher level of investors' trust in the securities markets. We

464 15 U.S.C. 78w(a)(2).

465 15 U.S.C. 78c(f).

believe that this increased investor trust in the fairness of the market will promote lower capital costs as more investment funds enter the market, and as investors generally demand a lower risk premium due to a reduced likelihood of securities fraud.[466] This, too, should promote the efficient allocation of capital formation.

In addition, there will be certain gains and losses in efficiency due to our rules, most of which were discussed in our cost-benefit analysis. As stated above, we believe that the final rules, by encouraging internal reporting without mandating it, allow whistleblowers to balance the potential increase in the probability and magnitude of an award by participating in an effective internal compliance mechanism against the particular risks that may result from doing so. By allowing potential whistleblowers to make this assessment and encouraging them to report internally in situations where their tips will be appropriately addressed, the final rules should promote efficiency in how violations are reported and resolved. Furthermore, issuers who previously may have underinvested in internal compliance programs may respond to our rules by making improvements in corporate governance generally,[467] and strengthening their internal compliance programs in particular. While these improvements will involve costs on companies, there should be an overall increased efficiency from the perspective of investors to the extent that these companies achieve a more optimal investment in these programs.

466 If investors fear theft, fraud, manipulation, insider trading, or conflicted investment advice, their trust in the markets will be low, both in the primary market for issuance or in the secondary market for trading. This would increase the cost of raising capital, which would impair capital formation – in the sense that it will be less than it would or should be if rules against such abuses were in effect and properly enforced and obeyed.

467 *See* Robert M. Bowen et al., "Whistle-Blowing: Target Firm Characteristics and Economic Consequences," working paper (2009) at 29, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890750 (cited in letter from CCMC) (documenting that firms respond to external whistleblowing with subsequent governance changes).

We do not believe the final rules will impose undue burdens on competition and, indeed, we believe the rules may have a potential pro-competitive effect. Specifically, by increasing the likelihood that misconduct will be detected, of securities law violations, the rules should reduce the unfair competitive advantages that some companies can achieve by engaging in undetected violations.

We are aware of the possible concern that smaller companies may bear a disproportionately greater cost under the final rules than larger companies. We do not believe this is likely for several reasons, however. First, we believe that the relative likelihood that any particular employee will blow the whistle on a possible violation should not significantly vary between smaller and larger companies, and thus we believe that the incidence of whistleblowing and the resulting costs borne by companies should be relatively consistent on a per-employee basis irrespective of a company's size. Second, because the final rules do not dictate the structure of effective compliance processes for internal reporting by employees under Rule 21F-4(c)(iii), including allowing companies to utilize upward reporting practices, we believe that companies of all sizes should be able to design cost-effective processes that meet their particular needs based on company size and structure. Overall, we do not believe these effects will result in undue burdens on competition.

## V. REGULATORY FLEXIBILITY ACT CERTIFICATION

In our proposing release, we certified that a regulatory flexibility analysis is not required because the persons that would be subject to the rules—individuals—are not "small entities" for purposes of the Regulatory Flexibility Act and the rules therefore would not have a significant economic impact on a substantial number of small entities.

One commenter disagreed with this conclusion, contending that our proposal not to require mandatory internal reporting will cause small businesses to experience significant costs and disruptions.[468] Notwithstanding the possibility of such indirect impacts, we disagree with the comment's conclusion that this means a Regulatory Flexibility Act analysis is required. These rules do not directly affect or impose responsibilities on small entities.[469]

## VI. STATUTORY AUTHORITY

The Commission is adopting rules and forms contained in this document under the authority set forth in Sections 3(b), 21F and 23(a) of the Exchange Act.

### List of Subjects in 17 CFR Parts 240 and 249

Securities

## TEXT OF THE AMENDMENTS

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows.

### Part 240 – General Rules and Regulations, Securities Exchange Act of 1934

1. The authority citation for part 240 is revised by adding the following citation in numerical order 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, 78-i, 78j, 78j-1, 78k, 78k-1, 78*l*, 78m, 78n,

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[468] *See* letter from Association for Corporate Counsel.

[469] In advancing the argument, the commenter relies on *Aeronautical Repair Station Association v. Federal Aviation Administration*, 494 F.3d 161 (D.C. Cir. 2007). This case is inapposite, however, because there the agency's own rulemaking release expressly stated that the rule *imposed responsibilities directly* on certain small business contractors. The court reaffirmed its prior holdings that the Regulatory Flexibility Act limits its application to small entities "which will be subject to the proposed regulation—that is, those small entities to which the proposed rule will apply." *Id.* at 176 (emphasis and internal quotations omitted). *See also Cement Kiln Recycling Coal v. EPA*, 255 F. 3d 855, 869 (D.C. Cir. 2001).

78n-1, 78*o*, 78*o*-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78*ll*, 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.

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Section 240.21F is also issued under Pub. L. No. 111-203, §922(a), 124 Stat. 1841 (2010).

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2. Add §§ 240.21F-1 through § 240.21F-16 to read as follows:

**Sec.**

**240.21F-1 General.**

**240.21F-2 Whistleblower status and retaliation protections.**

**240.21F-3 Payment of award.**

**240.21F-4 Other definitions.**

**240.21F-5 Amount of award.**

**240.21F-6 Criteria for determining amount of award.**

**240.21F-7 Confidentiality of submissions.**

**240.21F-8 Eligibility.**

**240.21F-9 Procedures for submitting original information.**

**240.21F-10 Procedures for making a claim for a whistleblower award in SEC actions that result in monetary sanctions in excess of $1,000,000**

**240.21F-11 Procedures for determining awards based upon a related action.**

**240.21F-12 Materials that may be used as the basis for an award determination and that may comprise the record on appeal.**

**240.21F-13 Appeals.**

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**§ 240.21F-1 General.**

Section 21F of the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78u-6), entitled "Securities Whistleblower Incentives and Protection," requires the Securities and Exchange Commission ("Commission") to pay awards, subject to certain limitations and conditions, to whistleblowers who provide the Commission with original information about violations of the federal securities laws. These rules describe the whistleblower program that the Commission has established to implement the provisions of Section 21F, and explain the procedures you will need to follow in order to be eligible for an award. You should read these procedures carefully because the failure to take certain required steps within the time frames described in these rules may disqualify you from receiving an award for which you otherwise may be eligible. Unless expressly provided for in these rules, no person is authorized to make any offer or promise, or otherwise to bind the Commission with respect to the payment of any award or the amount thereof. The Securities and Exchange Commission's Office of the Whistleblower administers our whistleblower program. Questions about the program or these rules should be directed to the SEC Office of the Whistleblower, 100 F Street, N.E., Washington, DC 20549-5631.

**§ 240.21F-2 Whistleblower status and retaliation protection.**

(a) Definition of a whistleblower. (1) You are a whistleblower if, alone or jointly with others, you provide the Commission with information pursuant to the procedures set forth in § 240.21F-9(a) of this chapter, and the information relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur. A whistleblower must be an individual. A company or another entity is not eligible to be a whistleblower.

(2) To be eligible for an award, you must submit original information to the Commission in accordance with the procedures and conditions described in §§240.21F-4, 240.21F-8, and 240.21F-9 of this chapter.

(b) Prohibition against retaliation: (1) For purposes of the anti-retaliation protections afforded by Section 21F(h)(1) of the Exchange Act (15 U.S.C. 78u-6(h)(1)), you are a whistleblower if:

(i) You possess a reasonable belief that the information you are providing relates to a possible securities law violation (or, where applicable, to a possible violation of the provisions set forth in 18 U.S.C. 1514A(a)) that has occurred, is ongoing, or is about to occur, and;

(ii) You provide that information in a manner described in Section 21F(h)(1)(A) of the Exchange Act (15 U.S.C. 78u-6(h)(1)(A)).

(iii) The anti-retaliation protections apply whether or not you satisfy the requirements, procedures and conditions to qualify for an award.

(2) Section 21F(h)(1) of the Exchange Act (15 U.S.C. 78u-6(h)(1)), including any rules promulgated thereunder, shall be enforceable in an action or proceeding brought by the Commission.

**§ 240.21F-3 Payment of awards.**

(a) Commission actions: Subject to the eligibility requirements described in §§240.21F-2, 240.21F-8, and 240.21F-16 of this chapter, the Commission will pay an award or awards to one or more whistleblowers who:

(1) Voluntarily provide the Commission

(2) With original information

(3) That leads to the successful enforcement by the Commission of a federal court or administrative action

(4) In which the Commission obtains monetary sanctions totaling more than $1,000,000.

**Note to paragraph (a):** The terms voluntarily, original information, leads to successful enforcement, action, and monetary sanctions are defined in § 240.21F-4 of this chapter.

(b) Related actions: The Commission will also pay an award based on amounts collected in certain related actions.

(1) A related action is a judicial or administrative action that is brought by:

(i) The Attorney General of the United States;

(ii) An appropriate regulatory authority;

(iii) A self-regulatory organization; or

(iv) A state attorney general in a criminal case, and is based on the same original information that the whistleblower voluntarily provided to the Commission, and that led the Commission to obtain monetary sanctions totaling more than $1,000,000.

**Note to paragraph (b):** The terms appropriate regulatory authority and self-regulatory organization are defined in § 240.21F-4 of this chapter.

(2) In order for the Commission to make an award in connection with a related action, the Commission must determine that the same original information that the whistleblower gave to the Commission also led to the successful enforcement of the related action under the same criteria described in these rules for awards made in connection with Commission actions. The Commission may seek assistance and confirmation from the authority bringing the related action in making this determination. The Commission will deny an award in connection with the related action if:

(i) The Commission determines that the criteria for an award are not satisfied; or

(ii) The Commission is unable to make a determination because the Office of the Whistleblower could not obtain sufficient and reliable information that could be used as the basis for an award determination pursuant to § 240.21F-12(a) of this chapter. Additional procedures apply to the payment of awards in related actions. These procedures are described in §§ 240.21F-11 and 240.21F-14 of this chapter.

(3) The Commission will not make an award to you for a related action if you have already been granted an award by the Commodity Futures Trading Commission ("CFTC") for that same action pursuant to its whistleblower award program under Section 23 of the Commodity Exchange Act (7 U.S.C. 26). Similarly, if the CFTC has previously denied an award to you in a related action, you will be precluded from

relitigating any issues before the Commission that the CFTC resolved against you as part of the award denial.

**§ 240.21F-4 Other definitions.**

(a) Voluntary submission of information. (1) Your submission of information is made voluntarily within the meaning of §§ 240.21F-1 through 240.21F-17 of this chapter if you provide your submission before a request, inquiry, or demand that relates to the subject matter of your submission is directed to you or anyone representing you (such as an attorney):

(i) By the Commission;

(ii) In connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board, or any self-regulatory organization; or

(iii) In connection with an investigation by Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority.

(2) If the Commission or any of these other authorities direct a request, inquiry, or demand as described in paragraph (1) of this section to you or your representative first, your submission will not be considered voluntary, and you will not be eligible for an award, even if your response is not compelled by subpoena or other applicable law. However, your submission of information to the Commission will be considered voluntary if you voluntarily provided the same information to one of the other authorities identified above prior to receiving a request, inquiry, or demand from the Commission.

(3) In addition, your submission will not be considered voluntary if you are required to report your original information to the Commission as a result of a pre-existing legal duty, a contractual duty that is owed to the Commission or to one of the

other authorities set forth in paragraph (1) of this section, or a duty that arises out of a judicial or administrative order.

(b) *Original information*. (1) In order for your whistleblower submission to be considered original information, it must be:

(i) Derived from your independent knowledge or independent analysis;

(ii) Not already known to the Commission from any other source, unless you are the original source of the information;

(iii) Not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless you are a source of the information; and

(iv) Provided to the Commission for the first time after July 21, 2010 (the date of enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*).

(2) Independent knowledge means factual information in your possession that is not derived from publicly available sources. You may gain independent knowledge from your experiences, communications and observations in your business or social interactions.

(3) Independent analysis means your own analysis, whether done alone or in combination with others. Analysis means your examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.

(4) The Commission will not consider information to be derived from your independent knowledge or independent analysis in any of the following circumstances:

(i) If you obtained the information through a communication that was subject to the attorney-client privilege, unless disclosure of that information would otherwise be permitted by an attorney pursuant to § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise;

(ii) If you obtained the information in connection with the legal representation of a client on whose behalf you or your employer or firm are providing services, and you seek to use the information to make a whistleblower submission for your own benefit, unless disclosure would otherwise be permitted by an attorney pursuant to § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise; or

(iii) In circumstances not covered by paragraphs (b)(4)(i) or (b)(4)(ii) of this section, if you obtained the information because you were:

(A) An officer, director, trustee, or partner of an entity and another person informed you of allegations of misconduct, or you learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law;

(B) An employee whose principal duties involve compliance or internal audit responsibilities, or you were employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for an entity;

(C) Employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law; or

(D) An employee of, or other person associated with, a public accounting firm, if you obtained the information through the performance of an engagement required of an independent public accountant under the federal securities laws (other than an audit subject to §240.21F-8(c)(4) of this chapter), and that information related to a violation by the engagement client or the client's directors, officers or other employees.

(iv) If you obtained the information by a means or in a manner that is determined by a United States court to violate applicable federal or state criminal law; or

(v) Exceptions. Paragraph (b)(4)(iii) of this section shall not apply if:

(A) You have a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors;

(B) You have a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct; or

(C) At least 120 days have elapsed since you provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or your supervisor, or since you received the information, if you received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or your supervisor was already aware of the information.

(vi) If you obtained the information from a person who is subject to this section, unless the information is not excluded from that person's use pursuant to this section, or you are providing the Commission with information about possible violations involving that person.

(5) The Commission will consider you to be an <u>original source</u> of the same information that we obtain from another source if the information satisfies the definition

of original information and the other source obtained the information from you or your representative. In order to be considered an original source of information that the Commission receives from Congress, any other authority of the federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, you must have voluntarily given such authorities the information within the meaning of these rules. You must establish your status as the original source of information to the Commission's satisfaction. In determining whether you are the original source of information, the Commission may seek assistance and confirmation from one of the other authorities described above, or from another entity (including your employer), in the event that you claim to be the original source of information that an authority or another entity provided to the Commission.

(6) If the Commission already knows some information about a matter from other sources at the time you make your submission, and you are not an original source of that information under paragraph (b)(5) of this section, the Commission will consider you an original source of any information you provide that is derived from your independent knowledge or analysis and that materially adds to the information that the Commission already possesses.

(7) If you provide information to the Congress, any other authority of the federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, or to an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law, and you, within 120 days, submit the same information to

the Commission pursuant to § 240.21F-9 of this chapter, as you must do in order for you to be eligible to be considered for an award, then, for purposes of evaluating your claim to an award under §§ 240.21F-10 and 240.21F-11 of this chapter, the Commission will consider that you provided information as of the date of your original disclosure, report or submission to one of these other authorities or persons. You must establish the effective date of any prior disclosure, report, or submission, to the Commission's satisfaction. The Commission may seek assistance and confirmation from the other authority or person in making this determination.

(c) Information that leads to successful enforcement. The Commission will consider that you provided original information that led to the successful enforcement of a judicial or administrative action in any of the following circumstances:

(1) You gave the Commission original information that was sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of your original information; or

(2) You gave the Commission original information about conduct that was already under examination or investigation by the Commission, the Congress, any other authority of the federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the PCAOB (except in cases where you were an original source of this information as defined in paragraph (b)(4) of this section), and your submission significantly contributed to the success of the action.

(3) You reported original information through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time you reported them to the Commission; the entity later provided your information to the Commission, or provided results of an audit or investigation initiated in whole or in part in response to information you reported to the entity; and the information the entity provided to the Commission satisfies either paragraph (c)(1) or (c)(2) of this section. Under this paragraph (c)(3), you must also submit the same information to the Commission in accordance with the procedures set forth in §240.21F-9 within 120 days of providing it to the entity.

(d) An action generally means a single captioned judicial or administrative proceeding brought by the Commission. Notwithstanding the foregoing:

(1) For purposes of making an award under § 240.21F-10 of this chapter, the Commission will treat as a Commission action two or more administrative or judicial proceedings brought by the Commission if these proceedings arise out of the same nucleus of operative facts; or

(2) For purposes of determining the payment on an award under § 240.21F-14 of this chapter, the Commission will deem as part of the Commission action upon which the award was based any subsequent Commission proceeding that, individually, results in a monetary sanction of $1,000,000 or less, and that arises out of the same nucleus of operative facts.

(e) Monetary sanctions means any money, including penalties, disgorgement, and interest, ordered to be paid and any money deposited into a disgorgement fund or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7246(b)) as a result of a Commission action or a related action.

(f) Appropriate regulatory agency means the Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act (15 U.S.C. 78c(a)(34)).

(g) Appropriate regulatory authority means an appropriate regulatory agency other than the Commission.

(h) Self-regulatory organization means any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board, and any other organizations that may be defined as self-regulatory organizations under Section 3(a)(26) of the Exchange Act (15 U.S.C. 78c(a)(26)).

**§ 240.21F-5 Amount of award.**

(a) The determination of the amount of an award is in the discretion of the Commission.

(b) If all of the conditions are met for a whistleblower award in connection with a Commission action or a related action, the Commission will then decide the percentage amount of the award applying the criteria set forth in § 240.21F-6 of this chapter and pursuant to the procedures set forth in §§ 240.21F-10 and 240.21F-11 of this chapter. The amount will be at least 10 percent and no more than 30 percent of the monetary sanctions that the Commission and the other authorities are able to collect. The percentage awarded in connection with a Commission action may differ from the percentage awarded in connection with a related action.

(c) If the Commission makes awards to more than one whistleblower in connection with the same action or related action, the Commission will determine an individual percentage award for each whistleblower, but in no event will the total amount awarded to all whistleblowers in the aggregate be less than 10 percent or greater than 30 percent of the amount the Commission or the other authorities collect.

**§ 240.21F-6 Criteria for determining amount of award.**

In exercising its discretion to determine the appropriate award percentage, the Commission may consider the following factors in relation to the unique facts and circumstances of each case, and may increase or decrease the award percentage based on its analysis of these factors. In the event that awards are determined for multiple whistleblowers in connection an action, these factors will be used to determine the relative allocation of awards among the whistleblowers.

(a) Factors that may increase the amount of a whistleblower's award. In determining whether to increase the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) Significance of the information provided by the whistleblower. The Commission will assess the significance of the information provided by a whistleblower to the success of the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) The nature of the information provided by the whistleblower and how it related to the successful enforcement action, including whether the reliability and completeness of the information provided to the Commission by the whistleblower resulted in the conservation of Commission resources;

(ii) The degree to which the information provided by the whistleblower supported one or more successful claims brought in the Commission or related action.

(2) Assistance provided by the whistleblower. The Commission will assess the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower provided ongoing, extensive, and timely cooperation and assistance by, for example, helping to explain complex transactions, interpreting key evidence, or identifying new and productive lines of inquiry;

(ii) The timeliness of the whistleblower's initial report to the Commission or to an internal compliance or reporting system of business organizations committing, or impacted by, the securities violations, where appropriate;

(iii) The resources conserved as a result of the whistleblower's assistance;

(iv) Whether the whistleblower appropriately encouraged or authorized others to assist the staff of the Commission who might otherwise not have participated in the investigation or related action;

(v) The efforts undertaken by the whistleblower to remediate the harm caused by the violations, including assisting the authorities in the recovery of the fruits and instrumentalities of the violations; and

(vi) Any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action.

(3) Law enforcement interest. The Commission will assess its programmatic interest in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws. In considering this factor, the Commission may take into account, among other things:

(i) The degree to which an award enhances the Commission's ability to enforce the federal securities laws and protect investors; and

(ii) The degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers' submission of significant information and assistance, even in cases where the monetary sanctions available for collection are limited or potential monetary sanctions were reduced or eliminated by the Commission because an entity self-reported a securities violation following the whistleblower's related internal disclosure, report, or submission.

(iii) Whether the subject matter of the action is a Commission priority, whether the reported misconduct involves regulated entities or fiduciaries, whether the whistleblower exposed an industry-wide practice, the type and severity of the securities violations, the age and duration of misconduct, the number of violations, and the isolated, repetitive, or ongoing nature of the violations; and

(iv) The dangers to investors or others presented by the underlying violations involved in the enforcement action, including the amount of harm or potential harm caused by the underlying violations, the type of harm resulting from or threatened by the underlying violations, and the number of individuals or entities harmed.

(4) Participation in internal compliance systems. The Commission will assess whether, and the extent to which, the whistleblower and any legal representative of the

whistleblower participated in internal compliance systems. In considering this factor, the Commission may take into account, among other things:

(i) Whether, and the extent to which, a whistleblower reported the possible securities violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commission; and

(ii) Whether, and the extent to which, a whistleblower assisted any internal investigation or inquiry concerning the reported securities violations.

(b) Factors that may decrease the amount of a whistleblower's award. In determining whether to decrease the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) Culpability. The Commission will assess the culpability or involvement of the whistleblower in matters associated with the Commission's action or related actions. In considering this factor, the Commission may take into account, among other things:

(i) The whistleblower's role in the securities violations;

(ii) The whistleblower's education, training, experience, and position of responsibility at the time the violations occurred;

(iii) Whether the whistleblower acted with scienter, both generally and in relation to others who participated in the violations;

(iv) Whether the whistleblower financially benefitted from the violations;

(v) Whether the whistleblower is a recidivist;

(vi) The egregiousness of the underlying fraud committed by the whistleblower; and

(vii) Whether the whistleblower knowingly interfered with the Commission's investigation of the violations or related enforcement actions.

(2) Unreasonable reporting delay. The Commission will assess whether the whistleblower unreasonably delayed reporting the securities violations. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower was aware of the relevant facts but failed to take reasonable steps to report or prevent the violations from occurring or continuing;

(ii) Whether the whistleblower was aware of the relevant facts but only reported them after learning about a related inquiry, investigation, or enforcement action; and

(iii) Whether there was a legitimate reason for the whistleblower to delay reporting the violations.

(3) Interference with internal compliance and reporting systems. The Commission will assess, in cases where the whistleblower interacted with his or her entity's internal compliance or reporting system, whether the whistleblower undermined the integrity of such system. In considering this factor, the Commission will take into account whether there is evidence provided to the Commission that the whistleblower knowingly:

(i) Interfered with an entity's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation;

(ii) Made any material false, fictitious, or fraudulent statements or representations that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations; and

(iii) Provided any false writing or document knowing the writing or document contained any false, fictitious or fraudulent statements or entries that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations.

**§ 240.21F-7 Confidentiality of submissions.**

(a) Section 21F(h)(2) of the Exchange Act (15 U.S.C. 78u-6(h)(2)) requires that the Commission not disclose information that could reasonably be expected to reveal the identity of a whistleblower, except that the Commission may disclose such information in the following circumstances:

(1) When disclosure is required to a defendant or respondent in connection with a federal court or administrative action that the Commission files or in another public action or proceeding that is filed by an authority to which we provide the information, as described below;

(2) When the Commission determines that it is necessary to accomplish the purposes of the Exchange Act (15 U.S.C. 78a) and to protect investors, it may provide your information to the Department of Justice, an appropriate regulatory authority, a self regulatory organization, a state attorney general in connection with a criminal investigation, any appropriate state regulatory authority, the Public Company Accounting Oversight Board, or foreign securities and law enforcement authorities. Each of these entities other than foreign securities and law enforcement authorities is subject to the confidentiality requirements set forth in Section 21F(h) of the Exchange Act (15 U.S.C. 78u-6(h)). The Commission will determine what assurances of confidentiality it deems appropriate in providing such information to foreign securities and law enforcement authorities.

(3) The Commission may make disclosures in accordance with the Privacy Act of 1974 (5 U.S.C. 552a).

(b) You may submit information to the Commission anonymously. If you do so, however, you must also do the following:

(1) You must have an attorney represent you in connection with both your submission of information and your claim for an award, and your attorney's name and contact information must be provided to the Commission at the time you submit your information;

(2) You and your attorney must follow the procedures set forth in § 240.21F-9 of this chapter for submitting original information anonymously; and

(3) Before the Commission will pay any award to you, you must disclose your identity to the Commission and your identity must be verified by the Commission as set forth in § 240.21F-10 of this chapter.

**§ 240.21F-8 Eligibility.**

(a) To be eligible for a whistleblower award, you must give the Commission information in the form and manner that the Commission requires. The procedures for submitting information and making a claim for an award are described in § 240.21F-9 through § 240.21F-11 of this chapter. You should read these procedures carefully because you need to follow them in order to be eligible for an award, except that the Commission may, in its sole discretion, waive any of these procedures based upon a showing of extraordinary circumstances.

(b) In addition to any forms required by these rules, the Commission may also require that you provide certain additional information. You may be required to:

(1) Provide explanations and other assistance in order that the staff may evaluate and use the information that you submitted;

(2) Provide all additional information in your possession that is related to the subject matter of your submission in a complete and truthful manner, through follow-up meetings, or in other forms that our staff may agree to;

(3) Provide testimony or other evidence acceptable to the staff relating to whether you are eligible, or otherwise satisfy any of the conditions, for an award; and

(4) Enter into a confidentiality agreement in a form acceptable to the Office of the Whistleblower, covering any non-public information that the Commission provides to you, and including a provision that a violation of the agreement may lead to your ineligibility to receive an award.

(c) You are not eligible to be considered for an award if you do not satisfy the requirements of paragraphs (a) and (b) of this section. In addition, you are not eligible if:

(1) You are, or were at the time you acquired the original information provided to the Commission, a member, officer, or employee of the Commission, the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization;

(2) You are, or were at the time you acquired the original information provided to the Commission, a member, officer, or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Exchange Act (15 U.S.C. 78c(a)(52));

(3) You are convicted of a criminal violation that is related to the Commission action or to a related action (as defined in § 240.21F-4 of this chapter) for which you otherwise could receive an award;

(4) You obtained the original information that you gave the Commission through an audit of a company's financial statements, and making a whistleblower submission would be contrary to requirements of Section 10A of the Exchange Act (15 U.S.C. 78j-a).

(5) You are the spouse, parent, child, or sibling of a member or employee of the Commission, or you reside in the same household as a member or employee of the Commission;

(6) You acquired the original information you gave the Commission from a person:

(i) Who is subject to paragraph (c)(4) of this section, unless the information is not excluded from that person's use, or you are providing the Commission with information about possible violations involving that person; or

(ii) With the intent to evade any provision of these rules; or

(7) In your whistleblower submission, your other dealings with the Commission, or your dealings with another authority in connection with a related action, you knowingly and willfully make any false, fictitious, or fraudulent statement or representation, or use any false writing or document knowing that it contains any false, fictitious, or fraudulent statement or entry with intent to mislead or otherwise hinder the Commission or another authority.

**§ 240.21F-9 Procedures for submitting original information.**

(a) To be considered a whistleblower under Section 21F of the Exchange Act (15 U.S.C. 78u-6(h)), you must submit your information about a possible securities law violation by either of these methods:

(1) Online, through the Commission's website located at www.sec.gov; or

(2) By mailing or faxing a Form TCR (Tip, Complaint or Referral) (referenced in § 249.1800 of this chapter) to the SEC Office of the Whistleblower, 100 F Street NE, Washington, DC 20549-5631, Fax (703) 813-9322.

(b) Further, to be eligible for an award, you must declare under penalty of perjury at the time you submit your information pursuant to paragraph (a)(1) or (2) of this section that your information is true and correct to the best of your knowledge and belief.

(c) Notwithstanding paragraphs (a) and (b) of this section, if you are providing your original information to the Commission anonymously, then your attorney must submit your information on your behalf pursuant to the procedures specified in paragraph (a) of this section. Prior to your attorney's submission, you must provide your attorney with a completed Form TCR (referenced in §249.1800 of this chapter) that you have signed under penalty of perjury. When your attorney makes her submission on your behalf, your attorney will be required to certify that he or she:

(1) Has verified your identity;

(2) Has reviewed your completed and signed Form TCR (referenced in §249.1800 of this chapter) for completeness and accuracy and that the information contained therein is true, correct and complete to the best of the attorney's knowledge,

information and belief;

(3) Has obtained your non-waivable consent to provide the Commission with your original completed and signed Form TCR (referenced in §249.1800 of this chapter) in the event that the Commission requests it due to concerns that you may have knowingly and willfully made false, fictitious, or fraudulent statements or representations, or used any false writing or document knowing that the writing or document contains any false fictitious or fraudulent statement or entry; and

(4) Consents to be legally obligated to provide the signed Form TCR (referenced in §249.1800 of this chapter) within seven (7) calendar days of receiving such request from the Commission.

(d) If you submitted original information in writing to the Commission after July 21, 2010 (the date of enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act) but before the effective date of these rules, your submission will be deemed to satisfy the requirements set forth in paragraphs (a) and (b) of this section. If you were an anonymous whistleblower, however, you must provide your attorney with a completed and signed copy of Form TCR (referenced in §249.1800 of this chapter) within 60 days of the effective date of these rules, your attorney must retain the signed form in his or her records, and you must provide of copy of the signed form to the Commission staff upon request by Commission staff prior to any payment of an award to you in connection with your submission. Notwithstanding the foregoing, you must follow the procedures and conditions for making a claim for a whistleblower award described in §§ 240.21F-10 and 240.21F-11 of this chapter.

## § 240.21F-10 Procedures for making a claim for a whistleblower award in SEC actions that result in monetary sanctions in excess of $1,000,000.

(a) Whenever a Commission action results in monetary sanctions totaling more than $1,000,000, the Office of the Whistleblower will cause to be published on the Commission's website a "Notice of Covered Action." Such Notice will be published subsequent to the entry of a final judgment or order that alone, or collectively with other judgments or orders previously entered in the Commission action, exceeds $1,000,000; or, in the absence of such judgment or order subsequent to the deposit of monetary sanctions exceeding $1,000,000 into a disgorgement or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002. A claimant will have ninety (90) days from the date of the Notice of Covered Action to file a claim for an award based on that action, or the claim will be barred.

(b) To file a claim for a whistleblower award, you must file Form WB-APP, *Application for Award for Original Information Provided Pursuant to Section 21F of the Securities Exchange Act of 1934* (referenced in § 249.1801 of this chapter). You must sign this form as the claimant and submit it to the Office of the Whistleblower by mail or fax. All claim forms, including any attachments, must be received by the Office of the Whistleblower within ninety (90) calendar days of the date of the Notice of Covered Action in order to be considered for an award.

(c) If you provided your original information to the Commission anonymously, you must disclose your identity on the Form WB-APP (referenced in § 249.1801 of this chapter), and your identity must be verified in a form and manner that is acceptable to the Office of the Whistleblower prior to the payment of any award.

(d) Once the time for filing any appeals of the Commission's judicial or administrative action has expired, or where an appeal has been filed, after all appeals in the action have been concluded, the staff designated by the Director of the Division of Enforcement ("Claims Review Staff") will evaluate all timely whistleblower award claims submitted on Form WB-APP (referenced in § 249.1801 of this chapter) in accordance with the criteria set forth in these rules. In connection with this process, the Office of the Whistleblower may require that you provide additional information relating to your eligibility for an award or satisfaction of any of the conditions for an award, as set forth in § 240.21F-(8)(b) of this chapter. Following that evaluation, the Office of the Whistleblower will send you a Preliminary Determination setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount.

(e) You may contest the Preliminary Determination made by the Claims Review Staff by submitting a written response to the Office of the Whistleblower setting forth the grounds for your objection to either the denial of an award or the proposed amount of an award. The response must be in the form and manner that the Office of the Whistleblower shall require. You may also include documentation or other evidentiary support for the grounds advanced in your response.

(1) Before determining whether to contest a Preliminary Determination, you may:

(i) Within thirty (30) days of the date of the Preliminary Determination, request that the Office of the Whistleblower make available for your review the materials from among those set forth in § 240.21F-12(a) of this chapter that formed the basis of the Claims Review Staff's Preliminary Determination.

(ii) Within thirty (30) calendar days of the date of the Preliminary Determination, request a meeting with the Office of the Whistleblower; however, such meetings are not required and the office may in its sole discretion decline the request.

(2) If you decide to contest the Preliminary Determination, you must submit your written response and supporting materials within sixty (60) calendar days of the date of the Preliminary Determination, or if a request to review materials is made pursuant to paragraph (e)(1) of this section, then within sixty (60) calendar days of the Office of the Whistleblower making those materials available for your review.

(f) If you fail to submit a timely response pursuant to paragraph (e) of this section, then the Preliminary Determination will become the Final Order of the Commission (except where the Preliminary Determination recommended an award, in which case the Preliminary Determination will be deemed a Proposed Final Determination for purposes of paragraph (h) of this section). Your failure to submit a timely response contesting a Preliminary Determination will constitute a failure to exhaust administrative remedies, and you will be prohibited from pursuing an appeal pursuant to § 240.21F-13 of this chapter.

(g) If you submit a timely response pursuant to paragraph (e) of this section, then the Claims Review Staff will consider the issues and grounds advanced in your response, along with any supporting documentation you provided, and will make its Proposed Final Determination.

(h) The Office of the Whistleblower will then notify the Commission of each Proposed Final Determination. Within thirty 30 days thereafter, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. If no

Commissioner requests such a review within the 30-day period, then the Proposed Final Determination will become the Final Order of the Commission. In the event a Commissioner requests a review, the Commission will review the record that the staff relied upon in making its determinations, including your previous submissions to the Office of the Whistleblower, and issue its Final Order.

(i) The Office of the Whistleblower will provide you with the Final Order of the Commission.

**§ 240.21F-11 Procedures for determining awards based upon a related action.**

(a) If you are eligible to receive an award following a Commission action that results in monetary sanctions totaling more than $1,000,000, you also may be eligible to receive an award based on the monetary sanctions that are collected from a related action (as defined in § 240.21F-3 of this chapter).

(b) You must also use Form WB-APP (referenced in § 249.1801 of this chapter) to submit a claim for an award in a related action. You must sign this form as the claimant and submit it to the Office of the Whistleblower by mail or fax as follows:

(1) If a final order imposing monetary sanctions has been entered in a related action at the time you submit your claim for an award in connection with a Commission action, you must submit your claim for an award in that related action on the same Form WB-APP (referenced in § 249.1801 of this chapter) that you use for the Commission action.

(2) If a final order imposing monetary sanctions in a related action has not been entered at the time you submit your claim for an award in connection with a Commission action, you must submit your claim on Form WB-APP (referenced in § 249.1801 of this

chapter) within ninety (90) days of the issuance of a final order imposing sanctions in the related action.

(c) The Office of the Whistleblower may request additional information from you in connection with your claim for an award in a related action to demonstrate that you directly (or through the Commission) voluntarily provided the governmental agency, regulatory authority or self-regulatory organization the same original information that led to the Commission's successful covered action, and that this information led to the successful enforcement of the related action. The Office of the Whistleblower may, in its discretion, seek assistance and confirmation from the other agency in making this determination.

(d) Once the time for filing any appeals of the final judgment or order in a related action has expired, or if an appeal has been filed, after all appeals in the action have been concluded, the Claims Review Staff will evaluate all timely whistleblower award claims submitted on Form WB-APP (referenced in § 249.1801 of this chapter) in connection with the related action. The evaluation will be undertaken pursuant to the criteria set forth in these rules. In connection with this process, the Office of the Whistleblower may require that you provide additional information relating to your eligibility for an award or satisfaction of any of the conditions for an award, as set forth in § 240.21F-(8)(b) of this chapter. Following this evaluation, the Office of the Whistleblower will send you a Preliminary Determination setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount.

(e) You may contest the Preliminary Determination made by the Claims Review Staff by submitting a written response to the Office of the Whistleblower setting forth the grounds for your objection to either the denial of an award or the proposed amount of an award. The response must be in the form and manner that the Office of the Whistleblower shall require. You may also include documentation or other evidentiary support for the grounds advanced in your response.

(1) Before determining whether to contest a Preliminary Determination, you may:

(i) Within thirty (30) days of the date of the Preliminary Determination, request that the Office of the Whistleblower make available for your review the materials from among those set forth in § 240.21F-12(a) of this chapter that formed the basis of the Claims Review Staff's Preliminary Determination.

(ii) Within thirty (30) days of the date of the Preliminary Determination, request a meeting with the Office of the Whistleblower; however, such meetings are not required and the office may in its sole discretion decline the request.

(2) If you decide to contest the Preliminary Determination, you must submit your written response and supporting materials within sixty (60) calendar days of the date of the Preliminary Determination, or if a request to review materials is made pursuant to paragraph (e)(1)(i) of this section, then within sixty (60) calendar days of the Office of the Whistleblower making those materials available for your review.

(f) If you fail to submit a timely response pursuant to paragraph (e) of this section, then the Preliminary Determination will become the Final Order of the Commission (except where the Preliminary Determination recommended an award, in which case the Preliminary Determination will be deemed a Proposed Final

Determination for purposes of paragraph (h) of this section). Your failure to submit a timely response contesting a Preliminary Determination will constitute a failure to exhaust administrative remedies, and you will be prohibited from pursuing an appeal pursuant to § 240.21F-13 of this chapter.

(g) If you submit a timely response pursuant to paragraph (e) of this section, then the Claims Review Staff will consider the issues and grounds that you advanced in your response, along with any supporting documentation you provided, and will make its Proposed Final Determination.

(h) The Office of the Whistleblower will notify the Commission of each Proposed Final Determination. Within thirty 30 days thereafter, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. If no Commissioner requests such a review within the 30-day period, then the Proposed Final Determination will become the Final Order of the Commission. In the event a Commissioner requests a review, the Commission will review the record that the staff relied upon in making its determinations, including your previous submissions to the Office of the Whistleblower, and issue its Final Order.

(i) The Office of the Whistleblower will provide you with the Final Order of the Commission.

**§ 240.21F-12 Materials that may form the basis of an award determination and that may comprise the record on appeal.**

(a) The following items constitute the materials that the Commission and the Claims Review Staff may rely upon to make an award determination pursuant to §§ 240.21F-10 and 240.21F-11 of this chapter:

(1) Any publicly available materials from the covered action or related action, including:

(i) The complaint, notice of hearing, answers and any amendments thereto;

(ii) The final judgment, consent order, or final administrative order;

(iii) Any transcripts of the proceedings, including any exhibits;

(iv) Any items that appear on the docket; and

(v) Any appellate decisions or orders.

(2) The whistleblower's Form TCR (referenced in §249.1800 of this chapter), including attachments, and other related materials provided by the whistleblower to assist the Commission with the investigation or examination;

(3) The whistleblower's Form WB-APP (referenced in §249.1800 of this chapter), including attachments, and any other filings or submissions from the whistleblower in support of the award application;

(4) Sworn declarations (including attachments) from the Commission staff regarding any matters relevant to the award determination;

(5) With respect to an award claim involving a related action, any statements or other information that the entity provides or identifies in connection with an award determination, provided the entity has authorized the Commission to share the information with the claimant. (Neither the Commission nor the Claims Review Staff may rely upon information that the entity has not authorized the Commission to share with the claimant); and

(6) Any other documents or materials including sworn declarations from third-parties that are received or obtained by the Office of the Whistleblower to assist the

Commission resolve the claimant's award application, including information related to the claimant's eligibility. (Neither the Commission nor the Claims Review Staff may rely upon information that the entity has not authorized the Commission to share with the claimant).

(b) These rules do not entitle claimants to obtain from the Commission any materials (including any pre-decisional or internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim) other than those listed in paragraph (a) of this section. Moreover, the Office of the Whistleblower may make redactions as necessary to comply with any statutory restrictions, to protect the Commission's law enforcement and regulatory functions, and to comply with requests for confidential treatment from other law enforcement and regulatory authorities. The Office of the Whistleblower may also require you to sign a confidentiality agreement, as set forth in § 240.21F-(8)(b)(4) of this chapter, before providing these materials.

**§ 240.21F-13 Appeals.**

(a) Section 21F of the Exchange Act (15 U.S.C. 78u-6) commits determinations of whether, to whom, and in what amount to make awards to the Commission's discretion. A determination of whether or to whom to make an award may be appealed within 30 days after the Commission issues its final decision to the United States Court of Appeals for the District of Columbia Circuit, or to the circuit where the aggrieved person resides or has his principal place of business. Where the Commission makes an award based on the factors set forth in § 240.21F-6 of this chapter of not less than 10 percent and not more than 30 percent of the monetary sanctions collected in the Commission or related action, the Commission's determination regarding the amount of an award (including the allocation of an award as between multiple whistleblowers, and any factual findings, legal conclusions, policy judgments, or discretionary assessments involving the Commission's consideration of the factors in § 240.21F-6 of this chapter) is not appealable.

(b) The record on appeal shall consist of the Preliminary Determination, the Final Order of the Commission, and any other items from those set forth in § 240.21F-12(a) of this chapter that either the claimant or the Commission identifies for inclusion in the record. The record on appeal shall not include any pre-decisional or internal deliberative process materials that are prepared exclusively to assist the Commission in deciding the claim (including the staff's Draft Final Determination in the event that the Commissioners reviewed the claim and issued the Final Order).

**§ 240.21F- 14 Procedures applicable to the payment of awards.**

(a) Any award made pursuant to these rules will be paid from the Securities and Exchange Commission Investor Protection Fund (the "Fund").

(b) A recipient of a whistleblower award is entitled to payment on the award only to the extent that a monetary sanction is collected in the Commission action or in a related action upon which the award is based.

(c) Payment of a whistleblower award for a monetary sanction collected in a Commission action or related action shall be made following the later of:

(1) The date on which the monetary sanction is collected; or

(2) The completion of the appeals process for all whistleblower award claims arising from:

(i) The Notice of Covered Action, in the case of any payment of an award for a monetary sanction collected in a Commission action; or

(ii) The related action, in the case of any payment of an award for a monetary sanction collected in a related action.

(d) If there are insufficient amounts available in the Fund to pay the entire amount of an award payment within a reasonable period of time from the time for payment specified by paragraph (c) of this section, then subject to the following terms, the balance of the payment shall be paid when amounts become available in the Fund, as follows:

(1) Where multiple whistleblowers are owed payments from the Fund based on awards that do not arise from the same Notice of Covered Action (or related action), priority in making these payments will be determined based upon the date that the collections for which the whistleblowers are owed payments occurred. If two or more of these collections occur on the same date, those whistleblowers owed payments based on these collections will be paid on a pro rata basis until sufficient amounts become available in the Fund to pay their entire payments.

(2) Where multiple whistleblowers are owed payments from the Fund based on awards that arise from the same Notice of Covered Action (or related action), they will share the same payment priority and will be paid on a pro rata basis until sufficient amounts become available in the Fund to pay their entire payments.

**§ 240.21F-15 No amnesty.**

The Securities Whistleblower Incentives and Protection provisions do not provide amnesty to individuals who provide information to the Commission. The fact that you may become a whistleblower and assist in Commission investigations and enforcement actions does not preclude the Commission from bringing an action against you based upon your own conduct in connection with violations of the federal securities laws. If such an action is determined to be appropriate, however, the Commission will take your cooperation into consideration in accordance with its Policy Statement Concerning Cooperation by Individuals in Investigations and Related Enforcement Actions (17 CFR § 202.12).

**§ 240.21F-16 Awards to whistleblowers who engage in culpable conduct.**

In determining whether the required $1,000,000 threshold has been satisfied (this threshold is further explained in § 240.21F-10 of this chapter) for purposes of making any award, the Commission will not take into account any monetary sanctions that the whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated. Similarly, if the Commission determines that a whistleblower is eligible for an award, any amounts that the whistleblower or such an entity pay in sanctions as a result of the action or related actions will not be included within the calculation of the amounts collected for purposes of making payments.

**§ 240.21F-17 Staff communications with individuals reporting possible securities law violations.**

(a) No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement (other than agreements dealing with information covered by § 240.21F-4(b)(4)(i) and § 240.21F-4(b)(4)(ii) of this chapter related to the legal representation of a client) with respect to such communications.

(b) If you are a director, officer, member, agent, or employee of an entity that has counsel, and you have initiated communication with the Commission relating to a possible securities law violation, the staff is authorized to communicate directly with you regarding the possible securities law violation without seeking the consent of the entity's counsel.

**PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934**

3. The authority citation for Part 249 is amended by adding the following citations in numerical order to read as follows:

**Authority:** 15 U.S.C. 78a, *et seq.* and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

*****

Section 249.1800 is also issued under Pub. L. No. 111.203, §922(a), 124 Stat 1841 (2010).

Section 249.1801 is also issued under Pub. L. No. 111.203, §922(a), 124 Stat 1841 (2010).

*****

4. Add Subpart S to read as follows:

**Subpart S -- Whistleblower forms**

**Sec. 249.1800 Form TCR, Tip, Complaint or Referral**

**249.1801 Form WB-APP, Application for Award for Original Information Submitted Pursuant to Section 21F of the Securities Exchange Act of 1934.**

**§ 249.1800 Form TCR, Tip, Complaint or Referral.**

This form may be used by anyone wishing to provide the SEC with information concerning a violation of the federal securities laws. The information provided may be disclosed to federal, state, local, or foreign agencies responsible for investigating, prosecuting, enforcing, or implementing the federal securities laws, rules, or regulations consistent with the confidentiality requirements set forth in Section 21F(h)(2) of the Exchange Act (15 U.S.C. 78u-6(h)(2)) and § 240.21F-7 of this chapter.

**§ 249.1801 Form WB-APP, Application for Award for Original Information Submitted Pursuant to Section 21F of the Securities Exchange Act of 1934.**

This form must be used by persons making a claim for a whistleblower award in connection with information provided to the SEC or to another agency in a related action. The information provided will enable the Commission to determine your eligibility for payment of an award pursuant to Section 21F of the Securities Exchange Act of 1934 (15 U.S.C. 78u-6). This information may be disclosed to Federal, state, local, or foreign agencies responsible for investigating, prosecuting, enforcing, or implementing the federal securities laws, rules, or regulations consistent with the confidentiality requirements set forth in Section 21F(h)(2) of the Exchange Act (15 U.S.C. 78u-6(h)(2)) and § 240.21F-7 of this chapter. Furnishing the information is voluntary, but a decision not to do so may result in you not being eligible for award consideration.

**Note**: The following Forms will not appear in the Code of Federal Regulations.

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, DC 20549**

# FORM TCR
# TIP, COMPLAINT OR REFERRAL

**A. INFORMATION ABOUT YOU**

| | | | |
|---|---|---|---|
| **COMPLAINANT 1:** 1. Last Name | First | | M.I. |
| 2. Street Address | | | Apartment/ Unit # |
| City | State/ Province | ZIP/ Postal Code | Country |
| 3. Telephone | Alt. Phone | E-mail Address | Preferred method of communication |
| 4. Occupation | | | |
| **COMPLAINANT 2:** 1. Last Name | First | | M.I. |
| 2. Street Address | | | Apartment/ Unit # |
| City | State/ Province | ZIP/ Postal Code | Country |
| 3. Telephone | Alt. Phone | E-mail Address | Preferred method of communication |
| 4. Occupation | | | |

**B. ATTORNEY'S INFORMATION (If Applicable - See Instructions)**

| | | | |
|---|---|---|---|
| 1. Attorney's Name | | | |
| 2. Firm Name | | | |
| 3. Street Address | | | |
| City | State/ Province | ZIP/ Postal Code | Country |
| 4. Telephone | Fax | E-mail Address | |

## C. TELL US ABOUT THE INDIVIDUAL OR ENTITY YOU HAVE A COMPLAINT AGAINST

**INDIVIDUAL/ENTITY 1:**

1. Type: ☐ Individual ☐ Entity

If an individual, specify profession:

If an entity, specify type:

2. Name

3. Street Address | Apartment/ Unit #

City | State/ Province | ZIP/ Postal Code | Country

4. Phone | E-mail Address | Internet address

**INDIVIDUAL/ENTITY 2:**

1. Type: ☐ Individual ☐ Entity

If an individual, specify profession:

If an entity, specify type:

2. Name

3. Street Address | Apartment/ Unit #

City | State/ Province | ZIP/ Postal Code | Country

4. Phone | E-mail Address | Internet Address

## D. TELL US ABOUT YOUR COMPLAINT

1. Occurrence Date (mm/dd/yyyy): / /

2. Nature of complaint:

3a. Has the complainant or counsel had any prior communication(s) with the SEC concerning this matter? YES ☐ NO ☐

3b. If the answer to 3a is "Yes," name of SEC staff member with whom the complainant or counsel communicated

4a. Has the complainant or counsel provided the information to any other agency or organization, or has any other agency or organization requested the information or related information from you? YES ☐ NO ☐

4b. If the answer to 4a is "Yes," please provide details. Use additional sheets if necessary.

4c. Name and contact information for point of contact at agency or organization, if known

5a. Does this complaint relate to an entity of which the complainant is or was an officer, director, counsel, employee, consultant or contractor?
YES ☐ NO ☐

5b. If the answer to question 5a is "yes," has the complainant reported this violation to his or her supervisor, compliance office, whistleblower hotline, ombudsman, or any other available mechanism at the entity for reporting violations? YES ☐ NO ☐

5c. If the answer to question 5b is "yes," please provide details. Use additional sheets if necessary.

5d. Date on which the complainant took the action(s) described in question 5b (mm/dd/yyyy): / /

6a. Has the complainant taken any other action regarding your complaint? YES ☐ NO ☐

6b. If the answer to question 6a is "yes," please provide details. Use additional sheets if necessary.

7a. Type of security or investment, if relevant

| | |
|---|---|
| 7b. Name of issuer or security, if relevant | 7c. Security/ Ticker Symbol or CUSIP no. |

8. State in detail all facts pertinent to the alleged violation. Explain why the complainant believes the acts described constitute a violation of the federal securities laws. Use additional sheets if necessary.

9. Describe all supporting materials in the complainant's possession and the availability and location of any additional supporting materials not in complainant's possession. Use additional sheets, if necessary.

10. Describe how and from whom the complainant obtained the information that supports this claim. If any information was obtained from an attorney or in a communication where an attorney was present, identify such information with as much particularity as possible. In addition, if any information was obtained from a public source, identify the source with as much particularity as possible. Attach additional sheets if necessary.

11. Identify with particularity any documents or other information in your submission that you believe could reasonably be expected to reveal your identity and explain the basis for your belief that your identity would be revealed if the documents were disclosed to a third party.

12. Provide any additional information you think may be relevant.

## E. ELIGIBILITY REQUIREMENTS AND OTHER INFORMATION

1. Are you, or were you at the time you acquired the original information you are submitting to us, a member, officer or employee of the Department of Justice, the Securities and Exchange Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision; the Public Company Accounting Oversight Board; any law enforcement organization; or any national securities exchange, registered securities association, registered clearing agency, or the Municipal Securities Rulemaking Board?

YES ☐ NO ☐

2. Are you, or were you at the time you acquired the original information you are submitting to us, a member, officer or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Securities Exchange Act of 1934 (15 U.S.C. §78c(a)(52))?

YES ☐ NO ☐

3. Did you acquire the information being provided to us through the performance of an engagement required under the federal securities laws by an independent public accountant?

YES ☐ NO ☐

4. Are you providing this information pursuant to a cooperation agreement with the SEC or another agency or organization?

YES ☐ NO ☐

5. Are you a spouse, parent, child, or sibling of a member or employee of the SEC, or do you reside in the same household as a member or employee of the SEC?

YES ☐ NO ☐

6. Are you providing this information before you (or anyone representing you) received any request, inquiry or demand that relates to the subject matter of your submission (i) from the SEC, (ii) in connection with an investigation, inspection or examination by the Public Company Accounting Oversight Board, or any self-regulatory organization; or (iii) in connection with an investigation by the Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority?

YES ☐ NO ☐

7. Are you currently a subject or target of a criminal investigation, or have you been convicted of a criminal violation, in connection with the information you are submitting to the SEC?

YES ☐ NO ☐

8. Did you acquire the information being provided to us from any person described in questions E1 through E7?

YES ☐ NO ☐

9. Use this space to provide additional details relating to your responses to questions 1 through 8. Use additional sheets if necessary.

| F. WHISTLEBLOWER'S DECLARATION | |
|---|---|
| I declare under penalty of perjury under the laws of the United States that the information contained herein is true, correct and complete to the best of my knowledge, information and belief. I fully understand that I may be subject to prosecution and ineligible for a whistleblower award if, in my submission of information, my other dealings with the SEC, or my dealings with another authority in connection with a related action, I knowingly and willfully make any false, fictitious, or fraudulent statements or representations, or use any false writing or document knowing that the writing or document contains any false, fictitious, or fraudulent statement or entry. | |
| Print name | |
| Signature | Date |

| G. COUNSEL CERTIFICATION | |
|---|---|
| I certify that I have reviewed this form for completeness and accuracy and that the information contained herein is true, correct and complete to the best of my knowledge, information and belief. I further certify that I have verified the identity of the whistleblower on whose behalf this form is being submitted by viewing the whistleblower's valid, unexpired government issued identification (*e.g.*, driver's license, passport) and will retain an original, signed copy of this form, with Section F signed by the whistleblower, in my records. I further certify that I have obtained the whistleblower's non-waiveable consent to provide the Commission with his or her original signed Form TCR upon request in the event that the Commission requests it due to concerns that the whistleblower may have knowingly and willfully made false, fictitious, or fraudulent statements or representations, or used any false writing or document knowing that the writing or document contains any false fictitious or fraudulent statement or entry; and that I consent to be legally obligated to do so within 7 calendar days of receiving such a request from the Commission. | |
| Signature | Date |

## Privacy Act Statement

This notice is given under the Privacy Act of 1974. This form may be used by anyone wishing to provide the SEC with information concerning a possible violation of the federal securities laws. We are authorized to request information from you by various laws: Sections 19 and 20 of the Securities Act of 1933, Sections 21 and 21F of the Securities Exchange Act of 1934, Section 321 of the Trust Indenture Act of 1939, Section 42 of the Investment Company Act of 1940, Section 209 of the Investment Advisers Act of 1940 and Title 17 of the Code of Federal Regulations, Section 202.5.

Our principal purpose in requesting information is to gather facts in order to determine whether any person has violated, is violating, or is about to violate any provision of the federal securities laws or rules for which we have enforcement authority. Facts developed may, however, constitute violations of other laws or rules. Further, if you are submitting information for the SEC's whistleblower award program pursuant to Section 21F of the Securities Exchange Act of 1934 (Exchange Act), the information provided will be used in connection with our evaluation of your or your client's eligibility and other factors relevant to our determination of whether to pay an award to you or your client.

The information provided may be used by SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities law; in proceedings in which the federal securities laws are in issue or the SEC is a party; to coordinate law enforcement activities between the SEC and other federal, state, local or foreign law enforcement agencies, securities self regulatory organizations, and foreign securities authorities; and pursuant to other routine uses as described in SEC-42 "Enforcement Files."

Furnishing the information requested herein is voluntary. However, a decision not provide any of the requested information, or failure to provide complete information, may affect our evaluation of your submission. Further, if you are submitting this information for the SEC whistleblower program and you do not execute the Whistleblower Declaration or, if you are submitting information anonymously, identify the attorney representing you in this matter, you may not be considered for an award.

Questions concerning this form maybe directed to the SEC Office of the Whistleblower, 100 F Street, NE, Washington, DC 20549, Tel. (202) 551-4790, Fax (703) 813-9322.

## Submission Procedures

- After manually completing this Form TCR, please send it by mail or delivery to the SEC Office of the Whistleblower, 100 F. Street, NE, Washington, DC 20549, or by facsimile to (703) 813-9322.

- You have the right to submit information anonymously. If you are submitting anonymously and you want to be considered for a whistleblower award, however, you *must* be represented by an attorney in this matter and Section B of this form must be completed. Otherwise, you may, but are not required, to have an attorney. If you are not represented by an attorney in this matter, you may leave Section B blank.

- **If you are submitting information for the SEC's whistleblower award program, you *must* submit your information either using this Form TCR or electronically through the SEC's Electronic Data Collection System, available on the SEC web site at [insert link].**

## Instructions for Completing Form TCR:

**Section A: Information about You**

Questions 1-3: Please provide the following information about yourself:

- Last name, first name, and middle initial
- Complete address, including city, state and zip code
- Telephone number and, if available, an alternate number where you can be reached
- Your e-mail address (to facilitate communications, we strongly encourage you to provide your email address),
- Your preferred method of communication; and
- Your occupation

**Section B: Information about Your Attorney. Complete this section only if you are represented by an attorney in this matter. You must be represented by an attorney, and this section must be completed, if you are submitting your information anonymously and you want to be considered for the SEC's whistleblower award program.**

Questions 1-4: Provide the following information about the attorney representing you in this matter:

- Attorney's name
- Firm name
- Complete address, including city, state and zip code
- Telephone number and fax number, and
- E-mail address

**Section C: Tell Us about the Individual and/or Entity You Have a Complaint Against.** If your complaint relates to more than two individuals and/or entities, you may attach additional sheets.

Question 1: Choose one of the following that best describes the individual or entity to which your complaint relates:

- **For Individuals**: accountant, analyst, attorney, auditor, broker, compliance officer, employee, executive officer or director, financial planner, fund manager, investment advisor representative, stock promoter, trustee, unknown, or other (specify).
- **For Entity**: bank, broker-dealer, clearing agency, day trading firm, exchange, Financial Industry Regulatory Authority, insurance company, investment advisor, investment advisor representative, investment company, Individual Retirement Account or 401(k) custodian/administrator, market maker, municipal securities dealers, mutual fund, newsletter company/investment publication company, on-line trading firm, private fund company (including hedge fund, private equity fund, venture capital fund, or real estate fund), private/closely held company, publicly held company, transfer agent/paying agent/registrar, underwriter, unknown, or other (specify).

Questions 2-4: For each subject, provide the following information, if known:

- Full name
- Complete address, including city, state and zip code
- Telephone number,
- E-mail address, and
- Internet address, if applicable

**Section D: Tell Us about Your Complaint**

Question 1: State the date (mm/dd/yyyy) that the alleged conduct began.

Question 2: Choose the option that you believe best describes the nature of your complaint. If you are alleging more than one violation, please list all that you believe may apply. Use additional sheets if necessary.

- Theft/misappropriation (advance fee fraud; lost or stolen securities; hacking of account)
- Misrepresentation/omission (false/misleading marketing/sales literature; inaccurate, misleading or non-disclosure by Broker-Dealer, Investment Adviser and Associated Person; false/material misstatements in firm research that were basis of transaction)
- Offering fraud (Ponzi/pyramid scheme; other offering fraud)
- Registration violations (unregistered securities offering)
- Trading (after hours trading; algorithmic trading; front-running; insider trading, manipulation of securities/prices; market timing; inaccurate quotes/pricing information; program trading; short selling; trading suspensions; volatility)
- Fees/mark-ups/commissions (excessive or unnecessary administrative fees; excessive commissions or sales fees; failure to disclose fees; insufficient notice of change in fees; negotiated fee problems; excessive mark-ups/markdowns; excessive or otherwise improper spreads)
- Corporate disclosure/reporting/other issuer matter (audit; corporate governance; conflicts of interest by management; executive compensation; failure to notify shareholders of corporate events; false/misleading financial statements, offering documents, press

releases, proxy materials; failure to file reports; financial fraud; Foreign Corrupt Practices Act violations; going private transactions; mergers and acquisitions; restrictive legends, including 144 issues; reverse stock splits; selective disclosure – Regulation FD, 17 CFR 243; shareholder proposals; stock options for employees; stock splits; tender offers)

- Sales and advisory practices (background information on past violations/integrity; breach of fiduciary duty/responsibility (IA); failure to disclose breakpoints; churning/excessive trading; cold calling; conflict of interest; abuse of authority in discretionary trading; failure to respond to investor; guarantee against loss/promise to buy back shares; high pressure sales techniques; instructions by client not followed; investment objectives not followed; margin; poor investment advice; Regulation E (Electronic Transfer Act); Regulation S-P, 17 CFR 248, (privacy issues); solicitation methods (non-cold calling; seminars); suitability; unauthorized transactions)
- Operational (bond call; bond default; difficulty buying/selling securities; confirmations/statements; proxy materials/prospectus; delivery of funds/proceeds; dividend and interest problems; exchanges/switches of mutual funds with fund family; margin (illegal extension of margin credit, Regulation T restrictions, unauthorized margin transactions); online issues (trading system operation); settlement (including T+1 or T=3 concerns); stock certificates; spam; tax reporting problems; titling securities (difficulty titling ownership); trade execution.
- Customer accounts (abandoned or inactive accounts; account administration and processing; identity theft affecting account; IPOs: problems with IPO allocation or eligibility; inaccurate valuation of Net Asset Value; transfer of account)
- Comments/complaints about SEC, Self-Regulatory Organization, and Securities Investor Protection Corporation processes & programs (arbitration: bias by arbitrators/forum, failure to pay/comply with award, mandatory arbitration requirements, procedural problems or delays; SEC: complaints about enforcement actions, complaints about rulemaking, failure to act; Self-Regulatory Organization: failure to act; Investor Protection:

inadequacy of laws or rules; SIPC: customer protection, proceedings and Broker-Dealer liquidations;

- Other (analyst complaints; market maker activities; employer/employee disputes; specify other).

Question 3a: State whether you or your counsel have had any prior communications with the SEC concerning this matter.

Question 3b: If the answer to question 3a is yes, provide the name of the SEC staff member with whom you or your counsel communicated.

Question 4a: Indicate whether you or your counsel have provided the information you are providing to the SEC to any other agency or organization.

Question 4b: If the answer to question 4a is yes, provide details.

Question 4c: Provide the name and contact information of the point of contact at the other agency or organization, if known.

Question 5a: Indicate whether your complaint relates to an entity of which you are, or were in the past, an officer, director, counsel, employee, consultant, or contractor.

Question 5b: If the answer to question 5a is yes, state whether you have reported this violation to your supervisor, compliance office, whistleblower hotline, ombudsman, or any other available mechanism at the entity for reporting violations.

Question 5c: If the answer to question 5b is yes, provide details.

Question 5d: Provide the date on which you took the actions described in questions 5a and 5b..

Question 6a: Indicate whether you have taken any other action regarding your complaint, including whether you complained to the SEC, another regulator, a law enforcement agency, or any other agency or organization; initiated legal action, mediation or arbitration, or initiated any other action.

Question 6b: If you answered yes to question 6a, provide details, including the date on which you took the action(s) described, the name of the person or entity to whom you directed any report or complaint and contact information for the person or entity, if known, and the complete case name, case number, and forum of any legal action you have taken. Use additional sheets if necessary.

Question 7a: Choose from the following the option that you believe best describes the type of security or investment at issue, if applicable:

- 1031 exchanges
- 529 plans
- American Depositary Receipts
- Annuities (equity-indexed annuities, fixed annuities, variable annuities)
- Asset-backed securities
- Auction rate securities
- Banking products (including credit cards)
- Certificates of deposit (CDs)
- Closed-end funds
- Coins and precious metals (gold, silver, etc.)
- Collateralized mortgage obligations (CMOs)
- Commercial paper
- Commodities (currency transactions, futures, stock index options)
- Convertible securities
- Debt (corporate, lower-rated or "junk", municipal)
- Equities (exchange-traded, foreign, Over-the-Counter, unregistered, linked notes)
- Exchange Traded Funds
- Franchises or business ventures
- Hedge funds
- Insurance contracts (not annuities)
- Money-market funds
- Mortgage-backed securities (mortgages, reverse mortgages)
- Mutual funds
- Options (commodity options, index options)

- Partnerships
- Preferred shares
- Prime bank securities/high yield programs
- Promissory notes
- Real estate (real estate investment trusts (REITs))
- Retirement plans ( 401(k), IRAs)
- Rights and warrants
- Structured note products
- Subprime issues
- Treasury securities
- U.S. government agency securities
- Unit investment trusts (UIT)
- Viaticals and life settlements
- Wrap accounts
- Separately Managed Accounts (SMAs)
- Unknown
- Other (specify)

Question 7b: Provide the name of the issuer or security, if applicable.

Question 7c: Provide the ticker symbol or CUSIP number of the security, if applicable.

Question 8: State in detail all the facts pertinent to the alleged violation. Explain why you believe the facts described constitute a violation of the federal securities laws. Attach additional sheets if necessary.

Question 9: Describe all supporting materials in your possession and the availability and location of additional supporting materials not in your possession. Attach additional sheets if necessary.

Question 10: Describe how you obtained the information that supports your allegation. If any information was obtained from an attorney or in a communication where an attorney was present, identify such information with as much particularity as possible. In addition, if any information was obtained from a public source, identify the source with as much particularity as possible. Attach additional sheets if necessary.

Question 11: You may use this space to identify any documents or other information in your submission that you believe could reasonably be expected to reveal your identity. Explain the basis for your belief that your identity would be revealed if the documents or information were disclosed to a third party.

Question 12: Provide any additional information you think may be relevant.

**Section E: Eligibility Requirements**

Question 1: State whether you are currently, or were at the time you acquired the original information that you are submitting to the SEC, a member, officer, or employee of the Department of Justice; the Securities and Exchange Commission; the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision; the Public Company Accounting Oversight Board; any law enforcement organization; or any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board

Question 2: State whether you are, or were you at the time you acquired the original information you are submitting to the SEC, a member, officer or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Securities Exchange Act of 1934.

- Section 3(a)(52) of the Exchange Act (15 U.S.C. §78c(a)(52)) currently defines "foreign financial regulatory authority" as "any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate participation of its members in activities listed above."

Question 3: State whether you acquired the information you are providing to the SEC through the performance of an engagement required under the securities laws by an independent public accountant.

Question 4: State whether you are providing the information pursuant to a cooperation agreement with the SEC or with any other agency or organization.

Question 5: State whether you are a spouse, parent, child or sibling of a member or employee of the SEC, or whether you reside in the same household as a member or employee of the SEC.

Question 6: State whether you acquired the information you are providing to the SEC from any individual described in Question 1 through 5 of this Section.

Question 7: If you answered "yes" to questions 1 though 6, please provide details.

Question 8a: State whether you are providing the information you are submitting to the SEC before you (or anyone representing you) received any request, inquiry or demand that relates to the subject matter of your submission in connection with: (i) an investigation, inspection or examination by the SEC, the Public Company Accounting Oversight Board, or any self-regulatory organization; or (ii) an investigation by Congress, or any other authority of the federal government, or a state Attorney General or securities regulatory authority?

Question 8b: If you answered "no" to questions 8a, please provide details. Use additional sheets if necessary.

Question 9a: State whether you are the subject or target of a criminal investigation or have been convicted of a criminal violation in connection with the information you are submitting to the SEC.

Question 9b: If you answered "yes" to question 9a, please provide details, including the name of the agency or organization that conducted the investigation or initiated the action against you, the name and telephone number of your point of contact at the agency or organization, if available and the investigation/case name and number, if applicable. Use additional sheets, if necessary.

**SECTION F: Whistleblower's Declaration.**

**You must sign this Declaration if you are submitting this information pursuant to the SEC whistleblower program and wish to be considered for an award. If you are submitting your information anonymously, you must still sign this Declaration, and you must provide your attorney with the original of this signed form.**

If you are not submitting your information pursuant to the SEC whistleblower program, you do not need to sign this Declaration.

**SECTION G: COUNSEL CERTIFICATION**

**If you are submitting this information pursuant to the SEC whistleblower program and are doing so anonymously, your attorney must sign the Counsel Certification section.**

If you are represented in this matter but you are not submitting your information pursuant to the SEC whistleblower program, your attorney does not need to sign the Counsel Certification Section.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

# FORM WB-APP

## APPLICATION FOR AWARD FOR ORIGINAL INFORMATION SUBMITTED PURSUANT TO SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934

**A. APPLICANT'S INFORMATION (REQUIRED FOR ALL SUBMISSIONS)**

| | | | |
|---|---|---|---|
| 1. Last Name | First | M.I. | Social Security No. |
| 2. Street Address | | | Apartment/ Unit # |
| City | State/ Province | ZIP Code | Country |
| 3. Telephone | Alt. Phone | E-mail Address | |

**B. ATTORNEY'S INFORMATION (IF APPLICABLE - SEE INSTRUCTIONS)**

| | | | |
|---|---|---|---|
| 1. Attorney's name | | | |
| 2. Firm Name | | | |
| 3. Street Address | | | |
| City | State/ Province | ZIP Code | Country |
| 4. Telephone | Fax | E-mail Address | |

**C. TIP/COMPLAINT DETAILS**

1. Manner in which original information was submitted to SEC: SEC website ☐ Mail ☐ Fax ☐ Other ☐ ____________

| | |
|---|---|
| 2a. Tip, Complaint or Referral number | 2b. Date TCR referred to in 2a submitted to SEC / / |

2c. Subject(s) of the Tip, Complaint or Referral:

**D. NOTICE OF COVERED ACTION**

| | |
|---|---|
| 1. Date of Notice of Covered Action to which claim relates: / / | 2. Notice Number: |
| 3a. Case Name | 3b. Case Number |

**E. CLAIMS PERTAINING TO RELATED ACTIONS**

1. Name of agency or organization to which you provided your information

2. Name and contact information for point of contact at agency or organization, if known.

| | |
|---|---|
| 3a. Date you provided your information / / | 3b. Date action filed by agency/organization / / |
| 4a. Case Name | 4b. Case number |

**F. ELIGIBILITY REQUIREMENTS AND OTHER INFORMATION**

1. Are you, or were you at the time you acquired the original information you submitted to us, a member, officer or employee of the Department of Justice, the Securities and Exchange Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision; the Public Company Accounting Oversight Board; any law enforcement organization; or any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board? YES ☐ NO ☐

| | |
|---|---|
| 2. Are you, or were you at the time you acquired the original information you submitted to us, a member, officer or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Securities Exchange Act of 1934 (15 U.S.C. §78c(a)(52))? | YES ☐ NO ☐ |
| 3. Did you obtain the information you are providing to us through the performance of an engagement required under the federal securities laws by an independent public accountant? | YES ☐ NO ☐ |
| 4. Did you provide the information identified in Section C above pursuant to a cooperation agreement with the SEC or another agency or organization? | YES ☐ NO ☐ |
| 5. Are you a spouse, parent, child, or sibling of a member or employee of the Commission, or do you reside in the same household as a member or employee of the Commission? | YES ☐ NO ☐ |
| 6. Did you acquire the information you are providing to us from any person described in questions F1 through F5? | YES ☐ NO ☐ |
| 7. If you answered "yes" to any of questions 1 through 6 above, please provide details. Use additional sheets if necessary. | |
| 8a. Did you provide the information identified in Section C above before you (or anyone representing you) received any request, inquiry or demand that relates to the subject matter of your submission (i) from the SEC, (ii) in connection with an investigation, inspection or examination by the Public Company Accounting Oversight Board, or any self-regulatory organization; or (iii) in connection with an investigation by the Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority? | YES ☐ NO ☐ |
| 8b. If you answered "yes" to question 8a, please provide details. Use additional sheets if necessary. | |
| 9a. Are you currently a subject or target of a criminal investigation, or have you been convicted of a criminal violation, in connection with the information upon which your application for an award is based? | YES ☐ NO ☐ |
| 9b. If you answered "Yes" to question 9a, please provide details. Use additional sheets if necessary. | |

## G. ENTITLEMENT TO AWARD

Explain the basis for your belief that you are entitled to an award in connection with your submission of information to us, or to another agency in a related action. Provide any additional information you think may be relevant in light of the criteria for determining the amount of an award set forth in Rule 21F-6 under the Securities Exchange Act of 1934. Include any supporting documents in your possession or control, and attach additional sheets, if necessary.

## H. DECLARATION

I declare under penalty of perjury under the laws of the United States that the information contained herein is true, correct and complete to the best of my knowledge, information and belief. I fully understand that I may be subject to prosecution and ineligible for a whistleblower award if, in my submission of information, my other dealings with the SEC, or my dealings with another authority in connection with a related action, I knowingly and willfully make any false, fictitious, or fraudulent statements or representations, or use any false writing or document knowing that the writing or document contains any false, fictitious, or fraudulent statement or entry.

| | |
|---|---|
| Signature | Date |

## Privacy Act Statement

This notice is given under the Privacy Act of 1974. We are authorized to request information from you by Section 21F of the Securities Exchange Act of 1934. Our principal purpose in requesting this information is to assist in our evaluation of your eligibility and other factors relevant to our determination of whether to pay a whistleblower award to you under Section 21F of the Exchange Act.

However, the information provided may be used by SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities law; in proceedings in which the federal securities laws are in issue or the SEC is a party; to coordinate law enforcement activities between the SEC and other federal, state, local or foreign law enforcement agencies, securities self regulatory organizations, and foreign securities authorities; and pursuant to other routine uses as described in SEC-42 "Enforcement Files."

Furnishing this information is voluntary, but a decision not do so, or failure to provide complete information, may result in our denying a whistleblower award to you, or may affect our evaluation of the appropriate amount of an award. Further, if you are submitting this information for the SEC whistleblower program and you do not execute the Declaration, you may not be considered for an award.

Questions concerning this form may be directed to the SEC Office of the Whistleblower, 100 F Street, NE, Washington, DC 20549-5631, Tel. (202) 551-4790, Fax (703) 813-9322.

### General

- This form should be used by persons making a claim for a whistleblower award in connection with information provided to the SEC or to another agency in a related action. In order to be deemed eligible for an award, you must meet all the requirements set forth in Section 21F of the Securities Exchange Act of 1934 and the rules thereunder.
- You must sign the Form WB-APP as the claimant. If you provided your information to the SEC anonymously, you must now disclose your identity on this form and your identity must be verified

in a form and manner that is acceptable to the Office of the Whistleblower prior to the payment of any award.

- If you are filing your claim in connection with information that you provided to the SEC, then your Form WB-APP, and any attachments thereto, **must be received by the SEC Office of the Whistleblower within sixty (60) days of the date of the Notice of Covered Action to which the claim relates.**

- If you are filing your claim in connection with information you provided to another agency in a related action, then your Form WB-APP, and any attachments there to, must be received by the SEC Office of the Whistleblower as follows:
  - If a final order imposing monetary sanctions has been entered in a related action at the time you submit your claim for an award in connection with a Commission action, **you must submit your claim for an award in that related action on the same Form WB-APP that you use for the Commission action.**
  - If a final order imposing monetary sanctions in a related action has not been entered at the time you submit your claim for an award in connection with a Commission action, **you must submit your claim on Form WB-APP within sixty (60) days of the issuance of a final order imposing sanctions in the related action.**

- You must submit your Form WB-APP to us in one of the following two ways:
  - By mailing or delivering the signed form to the SEC Office of the Whistleblower, 100 F Street

    NE, Washington, DC 20549-5631; or
  - By faxing the signed form to (703) 813-9322.

## Instructions for Completing Form WB-APP

### Section A: Applicant's Information

Questions 1-3: Provide the following information about yourself:

- First and last name, and middle initial
- Complete address, including city, state and zip code
- Telephone number and, if available, an alternate number where you can be reached
- E-mail address

### Section B: Attorney's Information. If you are represented by an attorney in this matter, provide the information requested. If you are not representing an attorney in this matter, leave this Section blank.

Questions 1-4: Provide the following information about the attorney representing you in this matter:

- Attorney's name
- Firm name
- Complete address, including city, state and zip code
- Telephone number and fax number, and
- E-mail address.

### Section C: Tip/Complaint Details

Question 1: Indicate the manner in which your original information was submitted to the SEC.

Question 2a: Include the TCR (Tip, Complaint or Referral) number to which this claim relates.

Question 2b: Provide the date on which you submitted your information to the SEC.

Question 2c: Provide the name of the individual(s) or entity(s) to which your complaint related.

### Section D: Notice of Covered Action

The process for making a claim for a whistleblower award begins with the publication of a "Notice of a Covered Action" on the Commission's website. This notice is published whenever a judicial or administrative action brought by the Commission results in the imposition of monetary sanctions exceeding $1,000,000. The Notice is published on the Commission's website subsequent to the entry of a final judgment or order in the action that by itself, or collectively with other judgments or orders previously entered in the action, exceeds the $1,000,000 threshold.

Question 1: Provide the date of the Notice of Covered Action to which this claim relates.

Question 2: Provide the notice number of the Notice of Covered Action.

Question 3a: Provide the case name referenced in Notice of Covered Action.

Question 3b: Provide the case number referenced in Notice of Covered Action.

**Section E: Claims Pertaining to Related Actions**

Question 1: Provide the name of the agency or organization to which you provided your information.

Question 2: Provide the name and contact information for your point of contact at the agency or organization, if known.

Question 3a: Provide the date on which that you provided your information to the agency or organization referenced in question E1.

Question 3b: Provide the date on which the agency or organization referenced in question E1 filed the related action that was based upon the information you provided.

Question 4a: Provide the case name of the related action.

Question 4b: Provide the case number of the related action.

**Section F: Eligibility Requirements**

Question 1: State whether you are currently, or were at the time you acquired the original information that you submitted to the SEC a member, officer, or employee of the Department of Justice; the Securities and Exchange Commission; the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision; the Public Company Accounting Oversight Board; any law enforcement organization; or any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board

Question 2: State whether you are, or were you at the time you acquired the original information you submitted to the SEC, a member, officer or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in Section 3(a)(52) of the Securities Exchange Act of 1934.

- Section 3(a)(52) of the Exchange Act (15 U.S.C. §78c(a)(52)) currently defines "foreign financial regulatory authority" as "any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate participation of its members in activities listed above."

Question 3: Indicate whether you acquired the information you provided to the SEC through the performance of an engagement required under the securities laws by an independent public accountant.

Question 4: State whether you provided the information submitted to the SEC pursuant to a cooperation agreement with the SEC or with any other agency or organization.

Question 5: State whether you are a spouse, parent, child or sibling of a member or employee of the Commission, or whether you reside in the same household as a member or employee of the Commission.

Question 6: State whether you acquired the information you are providing to the SEC from any individual described in Question 1 through 5 of this Section.

Question 7: If you answered "yes" to questions 1 though 6, please provide details.

Question 8a: State whether you provided the information identified submitted to the SEC before you (or anyone representing you) received any request, inquiry or demand from the SEC, Congress, or any other federal, state or local authority, or any self regulatory organization, or the Public Company Accounting Oversight Board about a matter to which the information your submission was relevant.

Question 8b: If you answered "no" to questions 8a, please provide details. Use additional sheets if necessary.

Question 9a: State whether you are the subject or target of a criminal investigation or have been convicted of a criminal violation in connection with the information upon which your application for award is based.

Question 9b: If you answered "yes" to question 9a, please provide details, including the name of the agency or organization that conducted the investigation or initiated the action against you, the name and telephone number of your point of contact at the agency or organization, if available and the investigation/case name and number, if applicable. Use additional sheets, if necessary. If you previously provided this information on Form WB-DEC, you may leave this question blank, unless your response has changed since the time you submitted your Form WB-DEC.

**Section G: Entitlement to Award**

**This section is optional.** Use this section to explain the basis for your belief that you are entitled to an award in connection with your submission of information to us or to another agency in connection with a related action. Specifically address how you believe you voluntarily provided the Commission with original information that led to the successful enforcement of a judicial or administrative action filed by the Commission, or a related action. Refer to Rules 21F-3 and 21F-4 under the Exchange Act for further information concerning the relevant award criteria. You may attach additional sheets, if necessary.

Rule 21F-6 under the Exchange Act provides that in determining the amount of an award, the Commission will evaluate the following factors: (a) the significance of the information provided by a whistleblower to the success of the Commission action or related action; (b) the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the

Commission action or related action; (c) the programmatic interest of the Commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws; and (d) whether the award otherwise enhances the Commission's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers. Address these factors in your response as well.

Additional information about the criteria the Commission may consider in determining the amount of an award is available on the Commission's website at [insert WBO web page address]

**Section H: Declaration**

This section must be signed by the claimant.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: May 25, 2011

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-64547; File No. 4-631)

May 25, 2011

Joint Industry Plan; Notice of Filing of a National Market System Plan to Address Extraordinary Market Volatility by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated, Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, The Nasdaq Stock Market LLC, National Stock Exchange, Inc., New York Stock Exchange LLC, NYSE Amex LLC, and NYSE Arca, Inc.

Pursuant to Section 11A of the Securities Exchange Act of 1934 ("Act")[1] and Rule 608 thereunder[2], notice is hereby given that, on April 5, 2011, NYSE Euronext, on behalf of New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), and NYSE Arca, Inc. ("NYSE Arca"), and the following parties to the proposed National Market System Plan: BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated, Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, the Nasdaq Stock Market LLC, and National Stock Exchange, Inc. (collectively with NYSE, NYSE Amex, and NYSE Arca, the "Participants"), filed with the Securities and Exchange Commission (the "Commission") a proposed Plan to Address Extraordinary Market Volatility ("Plan").[3] A copy of the proposed Plan is attached as Exhibit A hereto. The Commission is publishing this notice to solicit comments on the proposed Plan from interested persons.[4]

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1 15 U.S.C. 78k-1.

2 17 CFR 242.608.

3 See Letter from Janet M. McGinness, Senior Vice President, Legal and Corporate Secretary, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated April 5, 2011.

4 For additional discussion about the Plan, including its relation to the single-stock circuit

I. Rule 608(a) of Regulation NMS

A. Purpose of the Plan

The Participants filed the proposed Plan in order to create a market-wide limit up-limit down mechanism that is intended to address extraordinary market volatility in "NMS Stocks," as defined in Rule 600(b)(47) of Regulation NMS under the Act.[5] The proposed Plan sets forth proposed procedures that provide for market-wide limit up-limit down requirements that would be designed to prevent trades in individual NMS Stocks from occurring outside of the specified Price Bands.[6] These limit up-limit down requirements would be coupled with Trading Pauses, as defined in Section I(X) of the proposed Plan, to accommodate more fundamental price moves (as opposed to erroneous trades or momentary gaps in liquidity).

As set forth in more detail in the proposed Plan, all trading centers[7] in NMS Stocks, including both those operated by Participants and those operated by members of Participants, would be required to establish, maintain, and enforce written policies and procedures that are reasonably designed to comply with the limit up-limit down and trading pause requirements specified in the proposed Plan.

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breakers, see discussion in Section II, infra.

5 17 CFR 242.600(b)(47). See also Section I(H) of the proposed Plan.

6 As set forth in Section V of the proposed Plan, the Price Bands shall consist of a Lower Price Band and an Upper Price Band for each NMS Stock. The Price Bands shall be based on a Reference Price that equals the arithmetic mean price of Eligible Reported Transactions for the NMS stock over the immediately preceding five-minute period. As defined in the proposed Plan, Eligible Reported Transactions shall have the meaning prescribed by the Operating Committee for the proposed Plan, and generally mean transactions that are eligible to update the sale price of an NMS Stock.

7 As defined in Section I(W) of the proposed Plan, a trading center shall have the meaning provided in Rule 600(b)(78) of Regulation NMS under the Exchange Act.

The single plan processor responsible for consolidation of information for an NMS Stock pursuant to Rule 603(b) of Regulation NMS under the Act[8] would be responsible for calculating and disseminating the applicable Price Bands as provided for in Section V of the proposed Plan. The Processor for each NMS stock would calculate and disseminate to the public a lower Price Band and an upper Price Band during regular trading hours, as defined in Section I(R) of the proposed Plan, for such NMS Stock. The Price Bands would be based on a reference price for each NMS Stock that equals the arithmetic mean price of Eligible Reported Transactions for the NMS stock over the immediately preceding five-minute period (except for periods following openings and reopenings). The Price Bands for an NMS Stock would be calculated by applying the Percentage Parameter[9] for such NMS Stock to the reference price, with the lower Price Band being a Percentage Parameter below the reference price, and the upper Price Band being a Percentage Parameter above the reference price.

Section VI of the proposed Plan sets forth the details of the operation of the limit up-limit down mechanism. Section VI of the proposed Plan provides that all trading centers in NMS Stocks, including both those operated by Participants and those operated by members of Participants, would be required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trades at prices that are below the lower Price Band or above the upper Price Band for an NMS Stock, consistent with the proposed Plan.

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8 17 CFR 242.603(b). The proposed Plan refers to this entity as the Processor.

9 As defined in Section (I)(M) of the proposed Plan, the Percentage Parameter shall mean the percentages for each tier of NMS Stocks set forth in Appendix A of the Plan. As such, the Percentage Parameters for Tier 1 NMS Stocks with a Reference Price of $1.00 or more shall be 5%, and the Percentage Parameters for Tier 2 NMS Stocks with a Reference Price of $1.00 or more shall be 10%. For Tier 1 and Tier 2 NMS Stocks with a Reference Price less than $1.00, the Percentage Parameters shall be the lesser of $0.15 or 75%. The Percentage Parameters for a Tier 2 NMS Stock that is a leveraged exchange-traded product shall be the applicable Percentage Parameter multiplied by the leverage ratio of such product.

As set forth in Section VI, when one side of the market for an individual security is outside the applicable Price Band (i.e., when the National Best Bid[10] is below the Lower Limit Band or the National Best Offer[11] is above the Upper Limit Band for an NMS Stock), the Processor would be required to disseminate such National Best Bid or National Best Offer with an appropriate flag identifying it as non-executable. When the other side of the market reaches the applicable Price Band (i.e., when the National Best Offer is equal to the Lower Limit Band or the National Best Bid is equal to the Upper Limit Band for an NMS Stock), the market for an individual security would enter a Limit State,[12] and the Processor would be required to disseminate such National Best Offer or National Best Bid with an appropriate flag identifying it as a Limit State Quotation.[13] Trading for an NMS Stock would exit a Limit State if, within 15 seconds of entering the Limit State, the entire size of all Limit State Quotations is executed or cancelled. If the market does not exit a Limit State within 15 seconds, then the Primary Listing Exchange[14] would declare a five-minute Trading Pause pursuant to Section VII of the proposed Plan.

The Participants believe that, if implemented, the limit up-limit down mechanism specified in the proposed Plan will reduce the negative impacts of sudden, unanticipated price movements in NMS Stocks, thereby protecting investors and promoting a fair and orderly

10 17 CFR 242.600(b)(42). See also Section I(G) of the proposed Plan.

11 Id.

12 As set forth in Section VI(B) of the proposed Plan, when trading for an NMS Stock enters a Limit State, the Processor shall cease calculating and disseminating updated Reference Prices and Price Bands for the NMS Stock until either trading exits the Limit State or trading resumes with an opening or re-opening as provided in Section V of the proposed Plan.

13 See Section I(D) of the proposed Plan.

14 See Section I(O) of the proposed Plan.

market. In particular, the Participants are proposing to adopt the Plan to address the type of sudden price movements that the market experienced on the afternoon of May 6, 2010.[15]

B. Governing or Constituent Documents

The governing documents of the Processor, as defined in Section I(P) of the proposed Plan, would not be affected by the proposed Plan, but if the proposed Plan is implemented, the Processor's obligations would change, as set forth in detail in the proposed Plan. In particular, as set forth in Section V of the proposed Plan, the Processor would be responsible for calculating and disseminating Price Bands during Regular Trading Hours, as defined in Section I(R) of the proposed Plan. Each Participant would take such actions as are necessary and appropriate as a party to the Market Data Plans, as defined in Section I(F) of the proposed Plan, to cause and enable the Processor for each NMS Stock to fulfill the functions set forth in the proposed Plan.

C. Implementation of Plan

The Participants propose that the initial date of the proposed Plan operations would be 120 calendar days following the publication of the Commission's order approving the proposed Plan in the Federal Register.

D. Development and Implementation Phases

The Participants propose that the Plan would be implemented as a one-year pilot program in two Phases, consistent with Section VIII of the proposed Plan. Phase I of proposed Plan implementation would apply immediately following the initial date of proposed Plan operations; Phase II of proposed Plan would commence six months after the initial date of the proposed Plan

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15 The limit up-limit down mechanism set forth in the proposed Plan would replace the existing single-stock circuit breaker pilot, described more fully in Section II, Solicitation of Comments. See e.g., Securities Exchange Act Release Nos. 62251 (June 10, 2010), 75 FR 34183 (June 16, 2010) (SR-FINRA-2010-025); 62883 (September 10, 2010), 75 FR 56608 (September 16, 2010) (SR-FINRA-2010-033).

or such earlier date as may be announced by the Processor with at least 30 days notice. During Phase I, the proposed Plan would apply only to Tier 1 NMS Stocks, as defined in Appendix A of the proposed Plan, and the first Price Bands would be calculated and disseminated 15 minutes after the start of Regular Trading Hours, as specified in Section V(A) of the proposed Plan, and no Price Bands would be calculated and disseminated less than 30 minutes before the end of Regular Trading Hours. In Phase II, the proposed Plan would fully apply to all NMS Stocks beginning at 9:30 a.m. ET and ending at 4:00 p.m. ET each trading day.

E. Analysis of Impact on Competition

The Participants do not believe that the proposed Plan imposes any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The Participants also do not believe that the proposed Plan introduces terms that are unreasonably discriminatory for the purposes of Section 11A(c)(1)(D) of the Act.[16]

F. Written Understanding or Agreements relating to Interpretation of, or Participation in, Plan

The Participants state that they have no written understandings or agreements relating to interpretation of the proposed Plan. Section II(C) of the proposed Plan sets forth how any entity registered as a national securities exchange or national securities association may become a Plan Participant.

G. Approval of Amendment of the Plan

Not applicable.

H. Terms and Conditions of Access

Section II(C) of the proposed Plan provides that any entity registered as a national securities exchange or national securities association under the Act may become a Participant by:

[16] 15 U.S.C. 78k-1(c)(1)(D).

(1) becoming a participant in the applicable Market Data Plans, as defined in Section I(F) of the proposed Plan; (2) executing a copy of the Plan, as then in effect; (3) providing each then-current Participant with a copy of such executed Plan; and (4) effecting an amendment to the Plan as specified in Section III(B) of the proposed Plan.

I. <u>Method of Determination and Imposition, and Amount of, Fees and Charges</u>

Not applicable.

J. <u>Method and Frequency of Processor Evaluation</u>

Not applicable.

K. <u>Dispute Resolution</u>

The proposed Plan does not include specific provisions regarding resolution of disputes between or among Participants. Section III(C) of the proposed Plan provides for each Participant to designate an individual to represent the Participant as a member of an Operating Committee.[17] No later than the initial date of the Plan, the Operating Committee would be required to designate one member of the Operating Committee to act as the Chair of the Operating Committee. The Operating Committee would monitor the procedures established pursuant to the Plan and advise the Participants with respect to any deficiencies, problems, or recommendations as the Operating Committee may deem appropriate. Any recommendation for an amendment to the Plan from the Operating Committee that receives an affirmative vote of at least two-thirds of the Participants, but is less than unanimous, would be submitted to the Commission as a request for an amendment to the Plan initiated by the Commission under Rule 608 of Regulation NMS under the Act.[18]

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[17] See Section I(J) of the proposed Plan.

[18] 17 CFR 242.608.

## II. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed National Market System Plan is consistent with the Act. A stated purpose of the proposed Plan is to address extraordinary market volatility, such as the sudden price movements that the market experienced on the afternoon of May 6, 2010. Since the events of May 6, 2010, staff of the Commission and the SROs have been working on a variety of initiatives to reduce the risk of a recurrence of the extraordinary market volatility in NMS stocks that was experienced on that day. One such initiative is the single-stock circuit breaker pilot program, which currently extends to securities included in the S&P 500 index, the Russell 1000® index, and select exchange-traded products.[19] The circuit breaker pilot is currently set to expire the earlier of August 11, 2011 or the date on which the limit up-limit down mechanism to address extraordinary market volatility, if adopted, applies.[20]

- To the extent that the proposed Plan, if approved, would replace the current single-stock circuit breaker pilot, what are the advantages of a limit up-limit down mechanism over the current circuit breaker pilot? How would the limit up-limit down mechanism improve upon the current circuit breaker pilot? Would the proposed limit up-limit down mechanism prevent erroneous trades from occurring? What, if any, are the advantages of the current circuit breaker pilot over the proposed limit up-limit down mechanism?
- With respect to competition, would the proposed Plan impact one category of

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19 See e.g., Securities Exchange Act Release Nos. 62251 (June 10, 2010), 75 FR 34183 (June 16, 2010) (SR-FINRA-2010-025); 62883 (September 10, 2010), 75 FR 56608 (September 16, 2010) (SR-FINRA-2010-033).

20 See e.g., Securities Exchange Act Release No. 64174 (April 4, 2011), 76 FR 19819 (April 8, 2011) (SR-NASDAQ-2011-042).

market participants more than others? What, if any, costs would market participants incur as a result of the proposed Plan? Would different market participants bear any such costs differently? How would any such competitive impacts under the proposed Plan differ from the competitive impact, if any, that market participants have experienced under the current circuit breaker pilot?

- What is "excessive short-term volatility?" Put another way, what level of volatility is appropriate in continuous trading, and at what point should circuit breakers or the proposed limit up-limit down mechanism take effect?
- Section IX of the proposed Plan provides that a Participant may withdraw from the Plan, upon obtaining approval from the Commission and upon providing not less than 30 days written notice to the other participants. How, if at all, does the analysis of the impact of the proposed Plan upon competition change if one or more participants are permitted to withdraw from the proposed Plan? Would the operation of the proposed Plan be impaired if one or more participants were permitted to withdraw from the Plan?
- Are the proposed percentage levels for the Price Bands appropriate? Are they sufficiently narrow to guard against excessive market volatility while sufficiently broad to allow trading to occur without triggering a Limit State too frequently? If not, what alternate percentage levels would be preferable?
- Is 15 seconds an appropriate maximum length of time for a particular security to be in a Limit State? Is it long enough to reasonably attract additional available liquidity without recourse to a Trading Pause? Is it short enough to reasonably limit any market uncertainty that might accompany a Limit State?

- Are the triggers for the Limit State appropriate? Would alternative triggers for entering the Limit State be more appropriate? For example, should a Limit State be entered when the National Best Bid falls below the Lower Limit Band (or the National Best Offer exceeds the Upper Limit Band), because at that point a seller (buyer) cannot submit a marketable order? What are the advantages and disadvantages of the proposed approach? What, if any, are the advantages of alternative approaches? Please describe any other potential alternative trigger, as well as its relative strengths and weaknesses.
- Are the conditions required to exit the Limit State appropriate? Should alternative or additional conditions be imposed in order to exit the Limit State, and why might those conditions be appropriate? For example, should more be required to confirm that the market for a particular security has rebounded from a Limit State than the removal of a Limit State Quotation, such as a confirming quote or trade within the Price Bands?
- Are the proposed procedures relating to the functioning of the Operating Committee appropriate? Do they appropriately balance the protection of individual Participant interests with the efficient operation of the Plan? Are there ways to improve the proposed procedures for handling a recommendation from the Operating Committee for an amendment to the Plan that receives substantial, but less than unanimous, support from Participants?
- Should the list of exchange-traded products proposed to be included in Phase I of the proposed Plan be expanded to include additional such products, i.e., other

exchange-traded products that have component securities that largely track the securities included in the S&P 500 and Russell 1000?

- Is the proposed phased-in implementation schedule workable? Why or why not? Should the implementation of Phase II of the proposed Plan be conditioned upon Commission approval?

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-631 on the subject line.

Paper comments:

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

All submissions should refer to File Number 4-631. 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/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between 10:00 a.m. and 3:00 p.m. Copies of the filing will also be available for inspection and copying at the Participants' principal offices. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number 4-631 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

EXHIBIT A

# PLAN TO ADDRESS EXTRAORDINARY MARKET VOLATILITY

## SUBMITTED TO

## THE SECURITIES AND EXCHANGE COMMISSION

## PURSUANT TO RULE 608 OF REGULATION NMS

## UNDER THE

## SECURITIES EXCHANGE ACT OF 1934

Table of Contents

<u>Preamble</u>

The Participants submit to the SEC this Plan establishing procedures to address extraordinary volatility in NMS Stocks. The procedures provide for market-wide limit up-limit down requirements that prevent trades in individual NMS Stocks from occurring outside of the specified Price Bands. These limit up-limit down requirements are coupled with Trading Pauses to accommodate more fundamental price moves. The Plan procedures are designed, among other things, to protect investors and promote fair and orderly markets. The Participants developed this Plan pursuant to Rule 608(a)(3) of Regulation NMS under the Exchange Act, which authorizes the Participants to act jointly in preparing, filing, and implementing national market system plans.

## I. Definitions

(A) "Eligible Reported Transactions" shall have the meaning prescribed by the Operating Committee and shall generally mean transactions that are eligible to update the last sale price of an NMS Stock.

(B) "Exchange Act" means the Securities Exchange Act of 1934, as amended.

(C) "Limit State" shall have the meaning provided in Section VI of the Plan.

(D) "Limit State Quotation" shall have the meaning provided in Section VI of the Plan.

(E) "Lower Price Band" shall have the meaning provided in Section V of the Plan.

(F) "Market Data Plans" shall mean the effective national market system plans through which the Participants act jointly to disseminate consolidated information in compliance with Rule 603(b) of Regulation NMS under the Exchange Act.

(G) "National Best Bid" and "National Best Offer" shall have the meaning provided in Rule 600(b)(42) of Regulation NMS under the Exchange Act.

(H) "NMS Stock" shall have the meaning provided in Rule 600(b)(47) of Regulation NMS under the Exchange Act.

(I) "Opening Price" shall mean the price of a transaction that opens trading on the Primary Listing Exchange, or, if the Primary Listing Exchange opens with quotations, the midpoint of those quotations.

(J) "Operating Committee" shall have the meaning provided in Section III(C) of the Plan.

(K) "Participant" means a party to the Plan.

(L) "Plan" means the plan set forth in this instrument, as amended from time to time in accordance with its provisions.

(M) "Percentage Parameter" shall mean the percentages for each tier of NMS Stocks set forth in Appendix A of the Plan.

(N) "Price Bands" shall have the meaning provided in Section V of the Plan.

(O) "Primary Listing Exchange" shall mean the Participant on which an NMS Stock is listed. If an NMS Stock is listed on more than one Participant, the Participant on which the NMS Stock has been listed the longest shall be the Primary Listing Exchange.

(P) "Processor" shall mean the single plan processor responsible for the consolidation of information for an NMS Stock pursuant to Rule 603(b) of Regulation NMS under the Exchange Act.

(Q) "Pro-Forma Reference Price" shall have the meaning provided in Section V(A)(2) of the Plan.

(R) "Regular trading hours" shall have the meaning provided in Rule 600(b)(64) of Regulation NMS under the Exchange Act.

(S) "Regulatory Halt" shall have the meaning specified in the Market Data Plans.

(T) "Reference Price" shall have the meaning provided in Section V of the Plan.

(U) "Reopening Price" shall mean the price of a transaction that reopens trading on the Primary Listing Exchange following a Trading Pause or a Regulatory Halt, or, if the Primary Listing Exchange reopens with quotations, the midpoint of those quotations.

(V) "SEC" shall mean the United States Securities and Exchange Commission.

(W) "Trading center" shall have the meaning provided in Rule 600(b)(78) of Regulation NMS under the Exchange Act.

(X) "Trading Pause" shall have the meaning provided in Section VII of the Plan.

(Y) "Upper Price Band" shall have the meaning provided in Section V of the Plan.

II. Parties

(A) List of Parties

The parties to the Plan are as follows:

(1) BATS Exchange, Inc.
8050 Marshall Drive
Lenexa, Kansas 66214

(2) BATS Y-Exchange, Inc.
8050 Marshall Drive
Lenexa, Kansas 66214

(3) Chicago Board Options Exchange, Incorporated
400 South LaSalle Street
Chicago, Illinois 60605

(4) Chicago Stock Exchange, Inc.
440 South LaSalle Street
Chicago, Illinois 60605

(5) EDGA Exchange, Inc.
545 Washington Boulevard
Sixth Floor
Jersey City, NJ 07310

(6) EDGX Exchange, Inc.
545 Washington Boulevard
Sixth Floor
Jersey City, NJ 07310

(7) Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006

(8) NASDAQ OMX BX, Inc.
One Liberty Plaza
New York, New York 10006

(9) NASDAQ OMX PHLX LLC
1900 Market Street

Philadelphia, Pennsylvania 19103

(10) The Nasdaq Stock Market LLC
1 Liberty Plaza
165 Broadway
New York, NY 10006

(11) National Stock Exchange, Inc.
101 Hudson, Suite 1200
Jersey City, NJ 07302

(12) New York Stock Exchange LLC
11 Wall Street
New York, New York 10005

(13) NYSE Amex LLC
20 Broad Street
New York, New York 10005

(14) NYSE Arca, Inc.
100 South Wacker Drive
Suite 1800
Chicago, IL 60606

(B) <u>Compliance Undertaking</u>

By subscribing to and submitting the Plan for approval by the SEC, each Participant agrees to comply with and to enforce compliance, as required by Rule 608(c) of Regulation NMS under the Exchange Act, by its members with the provisions of the Plan. To this end, each Participant shall adopt a rule requiring compliance by its members with the provisions of the Plan, and each Participant shall take such actions as are necessary and appropriate as a participant of the Market Data Plans to cause and enable the Processor for each NMS Stock to fulfill the functions set forth in this Plan.

(C) <u>New Participants</u>

The Participants agree that any entity registered as a national securities exchange or national securities association under the Exchange Act may become a Participant by: (1)

becoming a participant in the applicable Market Data Plans; (2) executing a copy of the Plan, as then in effect; (3) providing each then-current Participant with a copy of such executed Plan; and (4) effecting an amendment to the Plan as specified in Section III(B) of the Plan.

III. Amendments to Plan

(A) General Amendments

Except with respect to the addition of new Participants to the Plan, any proposed change in, addition to, or deletion from the Plan shall be effected by means of a written amendment to the Plan that: (1) sets forth the change, addition, or deletion; (2) is executed on behalf of each Participant; and, (3) is approved by the SEC pursuant to Rule 608 of Regulation NMS under the Exchange Act, or otherwise becomes effective under Rule 608 of Regulation NMS under the Exchange Act.

(B) New Participants

With respect to new Participants, an amendment to the Plan may be effected by the new national securities exchange or national securities association executing a copy of the Plan, as then in effect (with the only changes being the addition of the new Participant's name in Section II(A) of the Plan) and submitting such executed Plan to the SEC for approval. The amendment shall be effective when it is approved by the SEC in accordance with Rule 608 of Regulation NMS under the Exchange Act or otherwise becomes effective pursuant to Rule 608 of Regulation NMS under the Exchange Act.

(C) Operating Committee

(1) Each Participant shall select from its staff one individual to represent the Participant as a member of an Operating Committee, together with a substitute for such individual. The substitute may participate in deliberations of the Operating Committee and shall

be considered a voting member thereof only in the absence of the primary representative. Each Participant shall have one vote on all matters considered by the Operating Committee. No later than the initial date of Plan operations, the Operating Committee shall designate one member of the Operating Committee to act as the Chair of the Operating Committee.

(2) The Operating Committee shall monitor the procedures established pursuant to this Plan and advise the Participants with respect to any deficiencies, problems, or recommendations as the Operating Committee may deem appropriate. The Operating Committee shall establish specifications and procedures for the implementation and operation of the Plan that are consistent with the provisions of this Plan and the Appendixes thereto. With respect to matters in this paragraph, Operating Committee decisions shall be approved by a simple majority vote.

(3) Any recommendation for an amendment to the Plan from the Operating Committee that receives an affirmative vote of at least two-thirds of the Participants, but is less than unanimous, shall be submitted to the SEC as a request for an amendment to the Plan initiated by the Commission under Rule 608 of Regulation NMS.

## IV. Trading Center Policies and Procedures

All trading centers in NMS Stocks, including both those operated by Participants and those operated by members of Participants, shall establish, maintain, and enforce written policies and procedures that are reasonably designed to comply with the limit up - limit down requirements specified in Sections VI of the Plan, and to comply with the Trading Pauses specified in Section VII of the Plan.

V. Price Bands

(A) Calculation and Dissemination of Price Bands

(1) The Processor for each NMS stock shall calculate and disseminate to the public a Lower Price Band and an Upper Price Band during Regular Trading Hours for such NMS Stock. The Price Bands shall be based on a Reference Price for each NMS Stock that equals the arithmetic mean price of Eligible Reported Transactions for the NMS stock over the immediately preceding five-minute period (except for periods following openings and reopenings, which are addressed below). If no Eligible Reported Transactions for the NMS Stock have occurred over the immediately preceding five-minute period, the previous Reference Price shall remain in effect. The Price Bands for an NMS Stock shall be calculated by applying the Percentage Parameter for such NMS Stock to the Reference Price, with the Lower Price Band being a Percentage Parameter below the Reference Price, and the Upper Price Band being a Percentage Parameter above the Reference Price. The Price Bands shall be calculated beginning at 9:30 a.m. ET, and ending at 4:00 p.m. ET. Between 9:30 a.m. and 9:45 a.m. ET, and 3:35 p.m. and 4:00 p.m. ET, the Price Bands shall be calculated by applying double the Percentage Parameters set forth in Appendix A. If a Reopening Price does not occur within ten minutes after the beginning of a Trading Pause, the Price Band, for the first 30 seconds following the reopening after that Trading Pause, shall be calculated by applying triple the Percentage Parameters set forth in Appendix A.

(2) The Processor shall calculate a Pro-Forma Reference Price on a continuous basis during Regular Trading Hours, as specified in Section V(A)(1) of the Plan. If a Pro-Forma Reference Price has not moved by 1% or more from the Reference Price currently in effect, no new Price Bands shall be disseminated, and the current Reference Price shall remain the

effective Reference Price. When the Pro-Forma Reference Price has moved by 1% or more from the Reference Price currently in effect, the Pro-Forma Reference Price shall become the Reference Price, and the Processor shall disseminate new Price Bands based on the new Reference Price; provided, however, that each new Reference Price shall remain in effect for at least 30 seconds.

(B) Openings

(1) Except when a Regulatory Halt is in effect at the start of regular trading hours, the first Reference Price for a trading day shall be the Opening Price on the Primary Listing Exchange in an NMS Stock if such Opening Price occurs less than five minutes after the start of regular trading hours. During the period less than five minutes after the Opening Price, a Pro-Forma Reference Price shall be updated on a continuous basis to be the arithmetic mean price of Eligible Reported Transactions for the NMS Stock during the period following the Opening Price (including the Opening Price), and if it differs from the current Reference Price by 1% or more shall become the new Reference Price, except that a new Reference Price shall remain in effect for at least 30 seconds. Subsequent Reference Prices shall be calculated as specified in Section V(A) of the Plan.

(2) If the Opening Price on the Primary Listing Exchange in an NMS Stock does not occur within five minutes after the start of Regular Trading Hours, the first Reference Price for a trading day shall be the arithmetic mean price of Eligible Reported Transactions for the NMS Stock over the preceding five minute time period, and subsequent Reference Prices shall be calculated as specified in Section V(A) of the Plan.

(C) Reopenings

(1) Following a Trading Pause in an NMS Stock, and if the Primary Listing Exchange has not declared a Regulatory Halt, the next Reference Price shall be the Reopening Price on the Primary Listing Exchange if such Reopening Price occurs within ten minutes after the beginning of the Trading Pause, and subsequent Reference Prices shall be determined in the manner prescribed for normal openings, as specified in Section V(B)(1) of the Plan. If such Reopening Price does not occur within ten minutes after the beginning of the Trading Pause, the first Reference Price following the Trading Pause shall be equal to the last effective Reference Price before the Trading Pause. Subsequent Reference Prices shall be calculated as specified in Section V(A) of the Plan.

(2) Following a Regulatory Halt, the next Reference Price shall be the Opening or Reopening Price on the Primary Listing Exchange if such Opening or Reopening Price occurs within five minutes after the end of the Regulatory Halt, and subsequent Reference Prices shall be determined in the manner prescribed for normal openings, as specified in Section V(B)(1) of the Plan. If such Opening or Reopening Price has not occurred within five minutes after the end of the Regulatory Halt, the Reference Price shall be equal to the arithmetic mean price of Eligible Reported Transactions for the NMS Stock over the preceding five minute time period, and subsequent Reference Prices shall be calculated as specified in Section V(A) of the Plan.

VI. Limit Up-Limit Down Requirements

(A) Limitations on Trades and Quotations Outside of Price Bands

(1) All trading centers in NMS Stocks, including both those operated by Participants and those operated by members of Participants, shall establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trades at prices that are below the

Lower Limit Band or above the Upper Limit Band for an NMS Stock. Single-priced opening, reopening, and closing transactions on the Primary Listing Exchange, however, shall be excluded from this limitation.

(2) When a National Best Bid is below the Lower Limit Band or a National Best Offer is above the Upper Limit Band for an NMS Stock, the Processor shall disseminate such National Best Bid or National Best Offer with an appropriate flag identifying it as non-executable. When a National Best Offer is equal to the Lower Limit Band or a National Best Bid is equal to the Upper Limit Band for an NMS Stock, the Processor shall distribute such National Best Bid or National Best Offer with an appropriate flag identifying it as a "Limit State Quotation".

(3) All trading centers in NMS Stocks, including both those operated by Participants and those operated by members of Participants, shall establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the display of offers below the Lower Price Band and bids above the Upper Price Band for an NMS Stock. The Processor shall disseminate an offer below the Lower Price Band or bid above the Upper Price Band that may be submitted despite such reasonable policies and procedures, but with an appropriate flag identifying it as non-executable; provided, however, that any such bid or offer shall not be included in National Best Bid or National Best Offer calculations.

(B) <u>Entering and Exiting a Limit State</u>

(1) All trading for an NMS Stock shall immediately enter a Limit State if the National Best Offer equals the Lower Limit Band and does not cross the National Best Bid, or the National Best Bid equals the Upper Limit Band and does not cross the National Best Offer.

(2) When trading for an NMS Stock enters a Limit State, the Processor shall disseminate this information by identifying the relevant quotation (i.e., a National Best Offer that equals the Lower Price Band or a National Best Bid that equals the Upper Price Band) as a Limit State Quotation. At this point, the Processor shall cease calculating and disseminating updated Reference Prices and Price Bands for the NMS Stock until either trading exits the Limit State or trading resumes with an opening or re-opening as provided in Section V.

(3) Trading for an NMS Stock shall exit a Limit State if, within 15 seconds of entering the Limit State, the entire size of all Limit State Quotations are executed or cancelled.

(4) If trading for an NMS Stock exits a Limit State within 15 seconds of entry, the Processor shall immediately calculate and disseminate updated Price Bands based on a Reference Price that equals the arithmetic mean price of Eligible Reported Transactions for the NMS Stock over the immediately preceding five-minute period (including the period of the Limit State).

(5) If trading for an NMS Stock does not exit a Limit State within 15 seconds of entry, the Limit State will terminate when the Primary Listing Exchange declares a Trading Pause pursuant to Section VII of the Plan. If trading for an NMS Stock is in a Limit State at the end of Regular Trading Hours, the Limit State will terminate when the Primary Listing Exchange executes a closing transaction in the NMS Stock or five minutes after the end of Regular Trading Hours, whichever is earlier.

VII. Trading Pauses

(A) Declaration of Trading Pauses

If trading for an NMS Stock does not exit a Limit State within 15 seconds of entry during Regular Trading Hours, then the Primary Listing Exchange shall declare a Trading Pause for such NMS Stock and shall notify the Processor. The Processor shall disseminate this information to the public. No trades in an NMS Stock shall occur during a Trading Pause, but all bids and offers may be displayed.

(B) Reopening of Trading During Regular Trading Hours

(1) Five minutes after declaring a Trading Pause for an NMS Stock, and if the Primary Listing Exchange has not declared a Regulatory Halt, the Primary Listing Exchange shall attempt to reopen trading using its established reopening procedures. The Trading Pause shall end when the Primary Listing Exchange reports a Reopening Price.

(2) The Primary Listing Exchange shall notify the Processor if it is unable to reopen trading in an NMS Stock for any reason other than a significant order imbalance and if it has not declared a Regulatory Halt. The Processor shall disseminate this information to the public, and all trading centers may begin trading the NMS Stock at this time.

(3) If the Primary Listing Exchange does not report a Reopening Price within ten minutes after the declaration of a Trading Pause in an NMS Stock, and has not declared a Regulatory Halt, all trading centers may begin trading the NMS Stock.

(4) When trading begins after a Trading Pause, the Processor shall update the Price Bands as set forth in Section V(C)(1) of the Plan.

(C) Trading Pauses Within Five Minutes of the End of Regular Trading Hours

(1) If a Trading Pause for an NMS Stock is declared less than five minutes before the end of Regular Trading Hours, the Primary Listing Exchange shall attempt to execute a closing transaction using its established closing procedures. All trading centers may begin trading the NMS Stock when the Primary Listing Exchange executes a closing transaction.

(2) If the Primary Listing Exchange does not execute a closing transaction within five minutes after the end of Regular Trading Hours, all trading centers may begin trading the NMS Stock.

VIII. Implementation

(A) Phase I

(1) Phase I of Plan implementation shall apply immediately following the initial date of Plan operations.

(2) During Phase I, the Plan shall apply only to the Tier 1 NMS Stocks identified in Appendix A of the Plan.

(3) During Phase I, the first Price Bands for a trading day shall be calculated and disseminated 15 minutes after the start of Regular Trading Hours as specified in Section (V)(A) of the Plan. No Price Bands shall be calculated and disseminated less than 30 minutes before the end of Regular Trading Hours, and trading shall not enter a Limit State less than 25 minutes before the end of Regular Trading Hours.

(B) Phase II – Full Implementation

(1) Six months after the initial date of Plan operations, or such earlier date as may be announced by the Processor with at least 30 days notice, the Plan shall fully apply (i) to all NMS Stocks; and (ii) beginning at 9:30 a.m. ET, and ending at 4:00 p.m. ET each trading day.

IX. Withdrawal from Plan

If a Participant obtains SEC approval to withdraw from the Plan, such Participant may withdraw from the Plan at any time on not less than 30 days' prior written notice to each of the other Participants. At such time, the withdrawing Participant shall have no further rights or obligations under the Plan.

X. Counterparts and Signatures

The Plan may be executed in any number of counterparts, no one of which need contain all signatures of all Participants, and as many of such counterparts as shall together contain all such signatures shall constitute one and the same instrument.

IN WITNESS THEREOF, this Plan has been executed as of the __ day of _____ 2011 by each of the parties hereto.

| | |
|---|---|
| BATS EXCHANGE, INC. | BATS Y-EXCHANGE, INC. |
| BY:________________________ | BY:________________________ |
| CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED | CHICAGO STOCK EXCHANGE, INC. |
| BY:________________________ | BY:________________________ |
| EDGA EXCHANGE, INC. | EDGX EXCHANGE, INC. |
| BY:________________________ | BY:________________________ |
| FINANCIAL INDUSTRY REGULATORY AUTHORITY, INC. | NASDAQ OMX BX, INC. |
| BY:________________________ | BY:________________________ |
| NASDAQ OMX PHLX LLC | THE NASDAQ STOCK MARKET LLC |
| BY:________________________ | BY:________________________ |
| NATIONAL STOCK EXCHANGE, INC. | NEW YORK STOCK EXCHANGE LLC |
| BY:________________________ | BY:________________________ |

NYSE AMEX LLC

BY:__________________________

NYSE ARCA, INC.

BY:__________________________

**Appendix A – Percentage Parameters**

I. <u>Tier 1 NMS Stocks</u>

(1) Tier 1 NMS Stocks shall include all NMS Stocks included in the S&P 500 Index, the Russell 1000 Index, and the exchange-traded products listed on Schedule 1 to this Appendix.

(2) The Percentage Parameters for Tier 1 NMS Stocks with a Reference Price of $1.00 or more shall be 5%.

(3) The Percentage Parameters for Tier 1 NMS Stocks with a Reference Price less than $1.00 shall be the lesser of (a) $0.15 or (b) 75%.

II. <u>Tier 2 NMS Stocks</u>

(1) Tier 2 NMS Stocks shall include all NMS Stocks other than those in Tier 1.

(2) The Percentage Parameters for Tier 2 NMS Stocks with a Reference Price of $1.00 or more shall be 10%.

(3) The Percentage Parameters for Tier 2 NMS Stocks with a Reference Price less than $1.00 shall be the lesser of (a) $0.15 or (b) 75%.

(4) Notwithstanding the foregoing, the Percentage Parameters for a Tier 2 NMS Stock that is a leveraged exchange-traded product shall be the applicable Percentage Parameter set forth in clauses (2) or (3) above, multiplied by the leverage ratio of such product.

## Appendix A – Schedule 1

| Symbol | Name |
|---|---|
| AAXJ | iShares MSCI All Country Asia ex Japan Index Fund |
| ACWI | iShares MSCI ACWI Index Fund |
| ACWX | iShares MSCI ACWI ex US Index Fund |
| ADRE | BLDRS Emerging Markets 50 ADR Index Fund |
| AGG | iShares Barclays Aggregate Bond Fund |
| AGZ | iShares Barclays Agency Bond Fund |
| AMJ | JPMorgan Alerian MLP Index ETN |
| BAB | PowerShares Build America Bond Portfolio |
| BBH | Biotech HOLDRs Trust |
| BDG | PowerShares DB Base Metals Long ETN |
| BIK | SPDR S&P BRIC 40 ETF |
| BIL | SPDR Barclays Capital 1-3 Month T-Bill ETF |
| BIV | Vanguard Intermediate-Term Bond ETF |
| BKF | iShares MSCI BRIC Index Fund |
| BLV | Vanguard Long-Term Bond ETF |
| BND | Vanguard Total Bond Market ETF |
| BOS | PowerShares DB Base Metals Short ETN |
| BRF | Market Vectors Brazil Small-Cap ETF |
| BSV | Vanguard Short-Term Bond ETF |
| BWX | SPDR Barclays Capital International Treasury Bond ETF |
| CEW | WisdomTree Dreyfus Emerging Currency Fund |
| CFT | iShares Barclays Credit Bond Fund |
| CIU | iShares Barclays Intermediate Credit Bond Fund |
| CSJ | iShares Barclays 1-3 Year Credit Bond Fund |
| CUT | Claymore/Beacon Global Timber Index ETF |
| CVY | Claymore/Zacks Multi-Asset Income Index ETF |
| CWB | SPDR Barclays Capital Convertible Securities ETF |
| CYB | WisdomTree Dreyfus Chinese Yuan Fund |
| DBA | PowerShares DB Agriculture Fund |
| DBB | PowerShares DB Base Metals Fund |
| DBC | PowerShares DB Commodity Index Tracking Fund |
| DBO | PowerShares DB Oil Fund |
| DBP | PowerShares DB Precious Metals Fund |
| DBV | PowerShares DB G10 Currency Harvest Fund |
| DDG | ProShares Short Oil & Gas |
| DEM | WisdomTree Emerging Markets Equity Income Fund |
| DFJ | WisdomTree Japan SmallCap Dividend Fund |
| DGS | WisdomTree Emerging Markets SmallCap Dividend Fund |
| DIA | SPDR Dow Jones Industrial Average ETF Trust |
| DJP | iPath Dow Jones-UBS Commodity Index Total Return ETN/United States |
| DNO | United States Short Oil Fund |
| DOG | ProShares Short Dow30 |
| DVY | iShares Dow Jones Select Dividend Index Fund |

| Symbol | Name |
|---|---|
| DWM | WisdomTree DEFA Fund |
| DWX | SPDR S&P International Dividend ETF |
| ECH | iShares MSCI Chile Investable Market Index Fund |
| EEB | Claymore/BNY BRIC ETF |
| EEM | iShares MSCI Emerging Markets Index Fund/United States |
| EFA | iShares MSCI EAFE Index Fund |
| EFG | iShares MSCI EAFE Growth Index |
| EFV | iShares MSCI EAFE Value Index |
| EFZ | ProShares Short MSCI EAFE |
| EIS | iShares MSCI Israel Capped Index Fund |
| EMB | iShares JPMorgan USD Emerging Markets Bond Fund |
| EPI | WisdomTree India Earnings Fund |
| EPP | iShares MSCI Pacific ex-Japan Index Fund |
| EPU | iShares MSCI All Peru Capped Index Fund |
| EUM | ProShares Short MSCI Emerging Markets |
| EWA | iShares MSCI Australia Index Fund |
| EWC | iShares MSCI Canada Index Fund |
| EWD | iShares MSCI Sweden Index Fund |
| EWG | iShares MSCI Germany Index Fund |
| EWH | iShares MSCI Hong Kong Index Fund |
| EWI | iShares MSCI Italy Index Fund |
| EWJ | iShares MSCI Japan Index Fund |
| EWK | iShares MSCI Belgium Investable Market Index Fund |
| EWL | iShares MSCI Switzerland Index Fund |
| EWM | iShares MSCI Malaysia Index Fund |
| EWN | iShares MSCI Netherlands Investable Market Index Fund |
| EWO | iShares MSCI Austria Investable Market Index Fund |
| EWP | iShares MSCI Spain Index Fund |
| EWQ | iShares MSCI France Index Fund |
| EWS | iShares MSCI Singapore Index Fund |
| EWT | iShares MSCI Taiwan Index Fund |
| EWU | iShares MSCI United Kingdom Index Fund |
| EWW | iShares MSCI Mexico Investable Market Index Fund |
| EWX | SPDR S&P Emerging Small Cap ETF |
| EWY | iShares MSCI South Korea Index Fund |
| EWZ | iShares MSCI Brazil Index Fund |
| EZA | iShares MSCI South Africa Index Fund |
| EZU | iShares MSCI EMU Index Fund |
| FBT | First Trust NYSE Arca Biotechnology Index Fund |
| FCG | First Trust ISE-Revere Natural Gas Index Fund |
| FDN | First Trust Dow Jones Internet Index Fund |
| FNI | First Trust ISE Chindia Index Fund |
| FXA | CurrencyShares Australian Dollar Trust |
| FXB | CurrencyShares British Pound Sterling Trust |
| FXC | CurrencyShares Canadian Dollar Trust |

| Symbol | Name |
|---|---|
| FXD | First Trust Consumer Discretionary AlphaDEX Fund |
| FXE | CurrencyShares Euro Trust |
| FXF | CurrencyShares Swiss Franc Trust |
| FXI | iShares FTSE/Xinhua China 25 Index Fund |
| FXY | CurrencyShares Japanese Yen Trust |
| FXZ | First Trust Materials AlphaDEX Fund |
| GAZ | iPath Dow Jones-UBS Natural Gas Subindex Total Return ETN |
| GCC | GreenHaven Continous Commodity Index Fund |
| GDX | Market Vectors - Gold Miners ETF |
| GDXJ | Market Vectors Junior Gold Miners ETF |
| GLD | SPDR Gold Trust |
| GMF | SPDR S&P Emerging Asia Pacific ETF |
| GML | SPDR S&P Emerging Latin America ETF |
| GSG | iShares S&P GSCI Commodity Indexed Trust |
| GSP | iPath GSCI Total Return Index ETN |
| GUR | SPDR S&P Emerging Europe ETF |
| GVI | iShares Barclays Intermediate Government/Credit Bond Fund |
| GVT | Grail American Beacon Large Cap Value ETF |
| GWX | SPDR S&P International Small Cap ETF |
| GXC | SPDR S&P China ETF |
| HAO | Claymore/AlphaShares China Small Cap Index ETF |
| HYG | iShares iBoxx $ High Yield Corporate Bond Fund |
| IAI | iShares Dow Jones US Broker Dealers Index Fund |
| IAT | iShares Dow Jones US Regional Banks Index Fund |
| IAU | iShares COMEX Gold Trust |
| IBB | iShares Nasdaq Biotechnology Index Fund |
| ICF | iShares Cohen & Steers Realty Majors Index Fund |
| IDU | iShares Dow Jones US Utilities Sector Index Fund |
| IDX | Market Vectors - Indonesia Index ETF |
| IEF | iShares Barclays 7-10 Year Treasury Bond Fund |
| IEI | iShares Barclays 3-7 Year Treasury Bond Fund |
| IEO | iShares Dow Jones US Oil & Gas Exploration & Production Index Fund |
| IEV | iShares S&P Europe 350 Index Fund |
| IEZ | iShares Dow Jones US Oil Equipment & Services Index Fund |
| IFGL | iShares FTSE EPRA/NAREIT Developed Real Estate ex-US Index Fund |
| IGE | iShares S&P North American Natural Resources Sector Index Fund |
| IGF | iShares S&P Global Infrastructure Index Fund |
| IGM | iShares S&P North American Technology Sector Index Fund |
| IGN | iShares S&P North American Technology-Multimedia Networking Index Fund |
| IGV | iShares S&P North American Technology-Software Index Fund |
| IGW | iShares S&P North American Technology-Semiconductors Index Fund |
| IHE | iShares Dow Jones US Pharmaceuticals Index Fund |
| IHF | iShares Dow Jones US Healthcare Providers Index Fund |
| IHI | iShares Dow Jones US Medical Devices Index Fund |
| IJH | iShares S&P MidCap 400 Index Fund |

| Symbol | Name |
| --- | --- |
| IJJ | iShares S&P MidCap 400/BARRA Value Index Fund |
| IJK | iShares S&P MidCap 400 Growth Index Fund |
| IJR | iShares S&P SmallCap 600 Index Fund |
| IJS | iShares S&P SmallCap 600 Value Index Fund |
| IJT | iShares S&P SmallCap 600/BARRA Growth Index Fund |
| ILF | iShares S&P Latin America 40 Index Fund |
| INP | iPath MSCI India Index ETN |
| IOO | iShares S&P Global 100 Index Fund |
| IPE | SPDR Barclays Capital TIPS ETF |
| ITA | iShares Dow Jones US Aerospace & Defense Index Fund |
| ITB | iShares Dow Jones US Home Construction Index Fund |
| IVE | iShares S&P 500 Value Index Fund |
| IVV | iShares S&P 500 Index Fund/US |
| IVW | iShares S&P 500 Growth Index Fund |
| IWB | iShares Russell 1000 Index Fund |
| IWC | iShares Russell Microcap Index Fund |
| IWD | iShares Russell 1000 Value Index Fund |
| IWF | iShares Russell 1000 Growth Index Fund |
| IWL | iShares Russell Top 200 Index Fund |
| IWM | iShares Russell 2000 Index Fund |
| IWN | iShares Russell 2000 Value Index Fund |
| IWO | iShares Russell 2000 Growth Index Fund |
| IWP | iShares Russell Midcap Growth Index Fund |
| IWR | iShares Russell Midcap Index Fund |
| IWS | iShares Russell Midcap Value Index Fund |
| IWV | iShares Russell 3000 Index Fund |
| IWW | iShares Russell 3000 Value Index Fund |
| IWX | iShares Russell Top 200 Value Index Fund |
| IWY | iShares Russell Top 200 Growth Index Fund |
| IXC | iShares S&P Global Energy Sector Index Fund |
| IXG | iShares S&P Global Financials Sector Index Fund |
| IXJ | iShares S&P Global Healthcare Sector Index Fund |
| IXN | iShares S&P Global Technology Sector Index Fund |
| IXP | iShares S&P Global Telecommunications Sector Index Fund |
| IYC | iShares Dow Jones US Consumer Services Sector Index Fund |
| IYE | iShares Dow Jones US Energy Sector Index Fund |
| IYF | iShares Dow Jones US Financial Sector Index Fund |
| IYG | iShares Dow Jones US Financial Services Index Fund |
| IYH | iShares Dow Jones US Healthcare Sector Index Fund |
| IYJ | iShares Dow Jones US Industrial Sector Index Fund |
| IYK | iShares Dow Jones US Consumer Goods Sector Index Fund |
| IYM | iShares Dow Jones US Basic Materials Sector Index Fund |
| IYR | iShares Dow Jones US Real Estate Index Fund |
| IYT | iShares Dow Jones Transportation Average Index Fund |
| IYW | iShares Dow Jones US Technology Sector Index Fund |

| Symbol | Name |
|---|---|
| IYY | iShares Dow Jones US Index Fund |
| IYZ | iShares Dow Jones US Telecommunications Sector Index Fund |
| JJC | iPath Dow Jones-UBS Copper Subindex Total Return ETN |
| JJG | iPath Dow Jones-UBS Grains Subindex Total Return ETN |
| JKE | iShares Morningstar Large Growth Index Fund |
| JKL | iShares Morningstar Small Value Index Fund |
| JNK | SPDR Barclays Capital High Yield Bond ETF |
| JXI | iShares S&P Global Utilities Sector Index Fund |
| KBE | SPDR KBW Bank ETF |
| KCE | SPDR KBW Capital Markets ETF |
| KIE | SPDR KBW Insurance ETF |
| KOL | Market Vectors - Coal ETF |
| KRE | SPDR KBW Regional Banking ETF |
| KXI | iShares S&P Global Consumer Staples Sector Index Fund |
| LQD | iShares iBoxx Investment Grade Corporate Bond Fund |
| MBB | iShares Barclays MBS Bond Fund |
| MBG | SPDR Barclays Capital Mortgage Backed Bond ETF |
| MDY | SPDR S&P MidCap 400 ETF Trust |
| MINT | PIMCO Enhanced Short Maturity Strategy Fund |
| MLPI | UBS E-TRACS Alerian MLP Infrastructure ETN |
| MLPN | Credit Suisse Cushing 30 MLP Index ETN |
| MOO | Market Vectors - Agribusiness ETF |
| MUB | iShares S&P National Municipal Bond Fund |
| MXI | iShares S&P Global Materials Sector Index Fund |
| MYY | ProShares Short MidCap400 |
| OEF | iShares S&P 100 Index Fund |
| OIH | Oil Services Holders Trust |
| OIL | iPath Goldman Sachs Crude Oil Total Return Index ETN |
| OLO | PowerShares DB Crude Oil Long ETN |
| ONEQ | Fidelity NASDAQ Composite Index Tracking Stock ETF |
| PALL | ETFS Palladium Trust |
| PBW | Powershares WilderHill Clean Energy Portfolio |
| PCEF | PowerShares CEF Income Composite Portfolio |
| PCY | PowerShares Emerging Markets Sovereign Debt Portfolio |
| PFF | iShares S&P US Preferred Stock Index Fund |
| PGF | PowerShares Financial Preferred Portfolio |
| PGJ | Powershares Golden Dragon Halter USX China Portfolio |
| PGX | PowerShares Preferred Portfolio |
| PHB | PowerShares High Yield Corporate Bond Portfolio |
| PHO | PowerShares Water Resources Portfolio |
| PHYS | Sprott Physical Gold Trust |
| PID | PowerShares International Dividend Achievers Portfolio |
| PIN | PowerShares India Portfolio |
| PIO | PowerShares Global Water Portfolio |
| PMA | PowerShares Active Mega Cap Fund |

| Symbol | Name |
|---|---|
| PPH | Pharmaceutical HOLDRs Trust |
| PPLT | ETFS Platinum Trust |
| PQY | PowerShares Active AlphaQ Fund |
| PRF | Powershares FTSE RAFI US 1000 Portfolio |
| PRFZ | PowerShares FTSE RAFI US 1500 Small-Mid Portfolio |
| PSQ | ProShares Short QQQ |
| PVI | PowerShares VRDO Tax Free Weekly Portfolio |
| PWV | PowerShares Dynamic Large Cap Value Portfolio |
| PXH | PowerShares FTSE RAFI Emerging Markets Portfolio |
| PZA | PowerShares Insured National Municipal Bond Portfolio |
| QQQQ | Powershares QQQ |
| QTEC | First Trust NASDAQ-100 Technology Index Fund |
| REK | ProShares Short Real Estate |
| RFG | Rydex S&P Midcap 400 Pure Growth ETF |
| RJA | ELEMENTS Linked to the Rogers International Commodity Index - Agri Tot Return |
| RJI | ELEMENTS Linked to the Rogers International Commodity Index - Total Return |
| RKH | Regional Bank HOLDRs Trust |
| RPV | Rydex S&P 500 Pure Value ETF |
| RSP | Rydex S&P Equal Weight ETF |
| RSX | Market Vectors - Russia ETF |
| RTH | Retail HOLDRs Trust |
| RWJ | RevenueShares Small Cap Fund |
| RWK | RevenueShares Mid Cap Fund |
| RWL | RevenueShares Large Cap Fund |
| RWM | ProShares Short Russell2000 |
| RWR | SPDR Dow Jones REIT ETF |
| RWX | SPDR Dow Jones International Real Estate ETF |
| RZV | Rydex S&P Smallcap 600 Pure Value ETF |
| SBB | ProShares Short SmallCap600 |
| SBM | ProShares Short Basic Materials |
| SCHA | Schwab US Small-Cap ETF |
| SCHB | Schwab US Broad Market ETF |
| SCHE | Schwab Emerging Markets Equity ETF |
| SCHF | Schwab International Equity ETF |
| SCHX | Schwab US Large-Cap ETF |
| SCZ | iShares MSCI EAFE Small Cap Index Fund |
| SDY | SPDR S&P Dividend ETF |
| SEF | ProShares Short Financials |
| SGG | iPath Dow Jones-UBS Sugar Subindex Total Return ETN |
| SGOL | ETFS Gold Trust |
| SH | ProShares Short S&P500 |
| SHM | SPDR Nuveen Barclays Capital Short Term Municipal Bond ETF |
| SHV | iShares Barclays Short Treasury Bond Fund |
| SHY | iShares Barclays 1-3 Year Treasury Bond Fund |

| Symbol | Name |
|---|---|
| SIL | Global X Silver Miners ETF |
| SIVR | ETFS Silver Trust |
| SLV | iShares Silver Trust |
| SLX | Market Vectors - Steel Index Fund |
| SMH | Semiconductor HOLDRs Trust |
| SPY | SPDR S&P 500 ETF Trust |
| STPZ | PIMCO 1-5 Year US TIPS Index Fund |
| SUB | iShares S&P Short Term National AMT-Free Municipal Bond Fund |
| TAN | Claymore/MAC Global Solar Energy Index ETF |
| TBF | ProShares Short 20+ Year Treasury |
| TFI | SPDR Nuveen Barclays Capital Municipal Bond ETF |
| THD | iShares MSCI Thailand Index Fund |
| TIP | iShares Barclays TIPS Bond Fund |
| TLH | iShares Barclays 10-20 Year Treasury Bond Fund |
| TLT | iShares Barclays 20+ Year Treasury Bond Fund |
| TUR | iShares MSCI Turkey Index Fund |
| TUZ | PIMCO 1-3 Year U.S. Treasury Index Fund |
| UDN | PowerShares DB US Dollar Index Bearish Fund |
| UGA | United States Gasoline Fund LP |
| UNG | United States Natural Gas Fund LP |
| USO | United States Oil Fund LP |
| UUP | PowerShares DB US Dollar Index Bullish Fund |
| VAW | Vanguard Materials ETF |
| VB | Vanguard Small-Cap ETF |
| VBK | Vanguard Small-Cap Growth ETF |
| VBR | Vanguard Small-Cap Value ETF |
| VCIT | Vanguard Intermediate-Term Corporate Bond ETF |
| VCR | Vanguard Consumer Discretionary ETF |
| VCSH | Vanguard Short-Term Corporate Bond ETF |
| VDC | Vanguard Consumer Staples ETF |
| VDE | Vanguard Energy ETF |
| VEA | Vanguard Europe Pacific ETF |
| VEU | Vanguard FTSE All-World ex-US ETF |
| VFH | Vanguard Financials ETF |
| VGK | Vanguard European ETF |
| VGT | Vanguard Information Technology ETF |
| VHT | Vanguard Health Care ETF |
| VIG | Vanguard Dividend Appreciation ETF |
| VIS | Vanguard Industrials ETF |
| VNM | Market Vectors Vietnam ETF |
| VNQ | Vanguard REIT ETF |
| VO | Vanguard Mid-Cap ETF |
| VOE | Vanguard Mid-Cap Value Index Fund |
| VOT | Vanguard Mid-Cap Growth Index Fund |
| VPL | Vanguard Pacific ETF |

| Symbol | Name |
|---|---|
| VPU | Vanguard Utilities ETF |
| VSS | Vanguard FTSE All World ex-US Small-Cap ETF |
| VT | Vanguard Total World Stock Index Fund ETF |
| VTI | Vanguard Total Stock Market ETF |
| VTV | Vanguard Value ETF |
| VUG | Vanguard Growth ETF |
| VV | Vanguard Large-Cap ETF |
| VWO | Vanguard Emerging Markets ETF |
| VXF | Vanguard Extended Market ETF |
| VXX | iPATH S&P 500 VIX Short-Term Futures ETN |
| VXZ | iPATH S&P 500 VIX Mid-Term Futures ETN |
| VYM | Vanguard High Dividend Yield ETF |
| WIP | SPDR DB International Government Inflation-Protected Bond ETF |
| XBI | SPDR S&P Biotech ETF |
| XES | SPDR S&P Oil & Gas Equipment & Services ETF |
| XHB | SPDR S&P Homebuilders ETF |
| XLB | Materials Select Sector SPDR Fund |
| XLE | Energy Select Sector SPDR Fund |
| XLF | Financial Select Sector SPDR Fund |
| XLG | Rydex Russell Top 50 ETF |
| XLI | Industrial Select Sector SPDR Fund |
| XLK | Technology Select Sector SPDR Fund |
| XLP | Consumer Staples Select Sector SPDR Fund |
| XLU | Utilities Select Sector SPDR Fund |
| XLV | Health Care Select Sector SPDR Fund |
| XLY | Consumer Discretionary Select Sector SPDR Fund |
| XME | SPDR S&P Metals & Mining ETF |
| XOP | SPDR S&P Oil & Gas Exploration & Production ETF |
| XPH | SPDR S&P Pharmaceuticals ETF |
| XRT | SPDR S&P Retail ETF |
| XSD | SPDR S&P Semiconductor ETF |
| YXI | ProShares Short FTSE/Xinhua China 25 |

Commissioner Walter not participating
Commissioner Paredes Disapproved

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64553 / May 26, 2011**

| | |
|---|---|
| **In the Matters of**<br><br>**Bear Wagner Specialists LLC**<br>**Admin. Proc. File No. 3-11445**<br>**Fleet Specialist, Inc.**<br>**Admin. Proc. File No. 3-11446**<br>**LaBranche & Co. LLC**<br>**Admin. Proc. File No. 3-11447**<br>**Spear, Leeds & Kellogg Specialists LLC**<br>**Admin. Proc. File No. 3-11448**<br>**Van der Moolen Specialists USA, LLC**<br>**Admin. Proc. File No. 3-11449**<br>**Performance Specialist Group LLC**<br>**Admin. Proc. File No. 3-11558**<br>**SIG Specialists, Inc.**<br>**Admin. Proc. File No. 3-11559**<br><br>**Respondents.** | **ORDER APPROVING TRANSFER OF REMAINING DISTRIBUTION FUNDS TO THE U.S. TREASURY** |

In this order, we consider the use to be made of the money remaining in seven Fair Funds ("the distribution funds") created in connection with orders instituting and settling proceedings ("the settlement orders") against seven specialist firms ("the specialist firms") operating on the New York Stock Exchange ("NYSE"). Pursuant to the settlement orders, the specialist firms paid over $247 million in disgorgement and civil penalties into the distribution funds. After six distributions, $159.8 million remains in the funds ("the remaining funds").

On July 30, 2009, the Commission issued notice ("July 30 Notice") that the distribution funds would be closed and that the administrator had concluded that the remaining funds should be transferred to the United States Treasury. Exchange Act Rel. No. 60403 (July 30, 2009). The Commission requested public comment regarding this determination. After reviewing the comments we received, we agree that the remaining funds should be transferred to the Treasury.

## I. FACTS

### A. The Commission and the specialist firms settled charges that the firms failed to serve public customer orders over their own proprietary interests.

In March and July 2004, the Commission instituted proceedings against, and entered into settlements with, the seven specialist firms operating on the New York Stock Exchange (Bear Wagner Specialists LLC; Fleet Specialist, Inc. ("Fleet"); LaBranche & Co. LLC; Spear, Leeds & Kellogg Specialists LLC; Van der Moolen Specialists USA, LLC ("VDMS"); Performance Specialist Group LLC; SIG Specialists, Inc.). Exchange Act Rel. Nos. 49498–49502 and Nos. 50075–50076. Two specialist firms, VDMS and Fleet, submitted comments in response to the Commission's July 30 Notice. Fleet's comment was written on behalf of all the specialist firms.

In these proceedings, the Commission charged (and found) that the specialist firms had failed to satisfy their obligation to match executable public customer or "agency" buy and sell orders. Instead, the firms executed proprietary trades for their own account, primarily in the form of "interpositioning" and "trading ahead," obtaining a profit for themselves while simultaneously placing executable public customer orders at a disadvantage. Interpositioning occurs, for example, when a specialist firm buys stock for the firm's own account from a customer sell order, and then fills a customer buy order by selling from the firm's account at a higher price—thus realizing a profit from the spread. "Trading ahead" occurs, for example, when a specialist firm fills one agency order through a proprietary trade for the firm's account, and thereby improperly "trades ahead" of another executable agency order. As a result, the customer order that was traded ahead of is disadvantaged because it is executed at a price that is inferior to the price received by the dealer account.

The extent of the violative trading was determined through the use of a retroactive surveillance conducted by the NYSE, at the direction of the Commission's Office of Compliance Inspections and Examinations. This surveillance generated an exception report that identified a series of specific transactions where specialists had unlawfully either traded ahead of executable customer orders, or interpositioned themselves between two customer orders that should have been matched against one another. In order to account for possible false positives—due to system errors and the oral execution of orders in an open outcry auction market—the Commission's settlements only counted as violations those instances where the specialist traded for the proprietary account ahead of an executable agency order that had been visible on the specialist's book for a certain period of time, at least ten seconds. The exception report enabled the Commission staff and the NYSE to calculate precisely the dollar amount by which a particular customer order had been disadvantaged by a specific violative trade. The disgorgement paid by each specialist firm was therefore tied to the specific violative trades identified by the Commission staff and the NYSE. These transactions caused approximately $157 million in customer harm.

The settlement orders thus required, among other things, that the specialist firms pay, in the aggregate, roughly $157 million in disgorgement and almost $90 million in penalties. Each settlement order provided that the disgorgement and civil penalties attributable thereto would be added to a distribution fund. The proceeds of all seven funds would be jointly administered and distributed according to a plan drawn up by a fund administrator that we would appoint.

Each settlement order gave the administrator the task of identifying "the customers who were injured as a result of [the specialist firm's] trading violations as determined herein by the Commission staff and the [New York Stock Exchange]." *E.g.*, *In re Bear Wagner Specialists LLC*, Exchange Act Rel. No. 49498, at ¶ IV.E, 2004 WL 626586, at *12 (Mar. 30, 2004). The administrator would then use the distribution funds "(i) to pay the costs of administering the [p]lan; (ii) to reimburse injured customers for their loss; and (iii) to pay prejudgment interest to injured customers." *Id.* As to any residual funds not distributed or used to cover the costs of administering the plan, each settlement order stated that "[t]he Commission shall determine the appropriate use for the benefit of investors of any funds left in the Distribution Fund following such payments. Under no circumstances shall any part of the Distribution Fund be returned to [the specialist firm]." *Id.*

### B. Injured investors filed suit against the specialist firms in federal court.

Just before the Commission settled its administrative proceedings against the specialist firms, investors filed five actions in the U.S. District Court for the Southern District of New York, alleging, on behalf of a purported class, that the seven specialist firms violated the securities laws. *See In re NYSE Specialists Sec. Litig.*, No. 03 Civ. 8264 (RWS) (S.D.N.Y.). The district court consolidated the cases in May 2004, and appointed Empire Program, Inc. ("Empire") and California Public Employees' Retirement System ("CalPERS") as co-lead plaintiffs. (In February 2007, the district court issued an opinion disqualifying and removing Empire as co-lead plaintiff.) Empire and CalPERS submitted comments in response to the Commission's July 30 Notice. Another commenter, Robert J. Peacock, worked as an independent trader for Empire and another class member, Sea Carriers Corporation.

The district court certified a class on June 5, 2009. *In re NYSE Specialists Sec. Litig.,* 260 F.R.D. 55, 59–60 (S.D.N.Y. 2009). In its opinion, the court specifically addressed the overlap, or lack thereof, between the class action and the Commission's settlement in response to the specialist firms' argument that a class should not be certified because the class action was "duplicative" of the Commission's proceedings. *Id.* at 81. The court explained that even though the class action complaint alleged the same type of wrongdoing as that alleged by the Commission, the class action was "not duplicative" because it "only provides for relief for those violative transactions not yet accounted for" by the settlement. *Id.* (*citing* 405 F. Supp. 2d 281, 311 (S.D.N.Y. 2005), *aff'd and vacated in part on other grounds,* 503 F.3d 89 (2d Cir. 2007)); *see also id.* at 60 ("[N]o customer could recover with respect to trades already covered by the Specialist Firms' regulatory settlements."). Specifically, the certified class consists of those customers whose orders were allegedly disadvantaged by violative transactions that were not included in the Commission's settlements, namely customers whose trades fell in the 1 to 10 second time period. Thus, the transactions covered by the settlements and the transactions at issue in the pending class action are mutually exclusive.

### C. The administrator proposed a distribution plan that the Commission approved.

In October 2004, the Commission established the seven distribution funds described in the settlement orders and appointed Heffler, Radetich & Saitta L.L.P. ("Heffler") to serve as their administrator. Exchange Act Rel. Nos. 50529–50535. The October orders directed Heffler to create a distribution plan, which we published for comment on December 27, 2005 and approved, as modified, on May 17, 2006. Exchange Act Rel. Nos. 53025 and 53823. The plan was implemented on July 5, 2006. Exchange Act Rel. No. 54102.

Heffler's plan, as modified, consisted of three parts: identification, calculation, and distribution. As a first step, Heffler would identify the investors who were injured as a result of the violative transactions that had previously been identified by the staff of the Commission and the NYSE. Once Heffler identified the injured investors, Heffler would calculate the respective distribution amount, which would consist of the disgorgement amount tied to the specific violative transaction, plus "prejudgment interest" (covering the period from the date of the transaction to the date of the settlement order) and "post-judgment interest" (covering the period from the day following the entry of the settlement order to the date of distribution). Third, Heffler would pay out the distribution amounts on a rolling basis, seeking approval from the Commission prior to each distribution.

### D. Heffler identified injured investors and distributed checks totaling over $141 million in six distributions.

Pursuant to the plan and the terms of the settlement orders, Heffler set out to identify customers who were injured as a result of the previously identified violative trades. As stated, those trades were listed on an NYSE exception report that identified the stock and the clearing firm, as well as the date, time, and size of the order. The report listed over 2.6 million violative transactions and included the following information for each transaction: clearing member number, clearing member name, trade date, security symbol, firm mnemonics, branch and sequence codes, turn-around code, transaction type, number of shares, time of trade, specialist firm number, disgorgement amount, execution price, CUSIP number, and principal/agency code.

Heffler used the clearing firm numbers listed in the exception report to identify over 160 clearing firms. Heffler then sent an electronic file containing the applicable violative transactions to the respective clearing firm, and requested that the firm identify the customer or customers associated with each harmed transaction. A number of clearing firms indicated that they did not have the information to identify the underlying investor, and instead, directed Heffler to introducing broker-dealers to identify the underlying customer, or customers in the case of certain nominee accounts.

As a result, the process of identifying injured customers was labor intensive and required contacting approximately 7,022 entities (including clearing firms, broker-dealers, and nominees) and asking them to supply customer information relating to the specific trades identified in the NYSE exception report. Overall, Heffler was able to identify customers connected to approximately 2.065 million of the 2.661 million violative transactions. Because some of the violative transactions were entered in the name of nominee accounts, more than one injured customer could be connected to a particular violative trade. At the same time, some customers could be connected to multiple violative transactions.

After identifying the injured customers, Heffler proceeded to calculate each customer's distribution amount, which consisted of the disgorgement tied to the particular violative trade plus "pre- and post-judgment" interest. After getting Commission approval to distribute the funds, Heffler made six rolling distributions under the plan, issuing 564,755 checks totaling, in the aggregate, over $141 million consisting of disgorgement and interest. *See* Table 1.

**Table 1**

| **Disbursement Dates (Exch. Act Rel. No.)** | **Total** | **Disgorgement** | **Prejudgment** | **Post-Judgment** |
|---|---|---|---|---|
| Jul. 19, 2006 (54102) | $52,732,921.43 | $42,082,144.95 | $6,101,253.76 | $4,549,522.72 |
| Nov. 30, 2006 (54815) | $42,765,263.59 | $33,548,991.43 | $4,942,721.04 | $4,273,551.12 |
| Jun. 19, 2007 (55915) | $14,305,053.02 | $10,923,205.08 | $1,606,357.24 | $1,775,490.70 |
| Dec. 19, 2007 (56944) | $10,733,490.40 | $7,935,062.94 | $1,267,325.27 | $1,531,102.19 |
| Jun. 30, 2008 (58035) | $2,885,895.39 | $2,069,722.41 | $354,784.94 | $461,388.04 |
| Dec. 30, 2009 (61199A) | $18,016,066.99[1] | $12,258,318.38 | $1,816,110.21 | $3,292,552.00 |

Heffler has represented that it encountered a number of obstacles in its efforts to identify injured investors. In particular, many of the trades at issue were already several years old when Heffler began the process of identifying injured investors. Because of the passage of time and the retention periods specified in broker-dealer recordkeeping rules, many records necessary to identify injured investors were no longer available. Some of the records relating to the transactions were kept on outdated computer systems—and sometimes even on microfiche—and had to be accessed manually. In several instances, the broker-dealers themselves were no longer operating due to mergers, takeovers, or business closings. Despite Heffler's best efforts, the customers connected with approximately 22.4% of the violative transactions remain unidentified.

[1] This total includes an additional $649,086.40. In connection with this sixth and final distribution, the plan was modified to include a *de minimis* gross-up provision so that currently identified customers who would otherwise have received less than $5, instead received a $5 check. Heffler identified 192,713 such customers, and distributed $963,565.00 to them, instead of the $314,478.60 they would have received absent the gross-up. Exchange Act. Rel. No. 61199A, 2009 WL 4885569, at *2 (Dec. 17, 2009).

In addition, some of the customers who were successfully identified could not be located or were deceased,[2] while others failed to cash the checks that were sent to them. The checks that were ultimately returned to Heffler, mostly as undeliverable, totaled approximately $13 million. The uncashed (but unreturned) checks totaled approximately $24 million. Heffler has represented that, in its experience with settlement administration, checks for a relatively low dollar amount are often not cashed by the recipient. In this case, there are approximately 193,471 checks that either were returned or remain uncashed; of these, 125,607 are for amounts of $20 or less.

As part of the plan, Heffler sent a follow-up letter to the recipient of any outstanding check in an amount of $500 or more that was not returned to Heffler as undeliverable but that remained uncashed for more than 90 days. Even after the reminder letter was sent, less than ten percent of these customers subsequently cashed their checks.

Heffler has represented to the Commission that it has exhausted reasonable efforts to identify injured customers and to locate those customers it has successfully identified. Heffler has stated that it believes undertaking further efforts at this juncture to locate additional injured investors will be much less favorable due to the additional time that has passed since the damaged transactions originally occurred. Heffler has also concluded that additional efforts to reach identified investors, including employing additional locator services, would have an unknown success rate, would be expensive, and, given the time and effort involved, would not be warranted. As a result, Heffler has represented to the Commission that it has completed its efforts under the plan, that it should be discharged as the fund administrator, and that the distribution funds should be terminated.

### E. Following the distributions, $159.8 million remains in the distribution funds.

Despite Heffler's efforts to identify injured investors and distribute the funds, $159.8 million remains.

The residual is calculated as follows. The specialist firms paid disgorgement of $157.8 million and civil penalties of $89.4 million, for a total of $247.2 million. The distribution funds earned $30.1 million in interest, bringing the total to approximately $277.3 million. As indicated above, Heffler identified customers connected with approximately 77.6% of the violative transactions, and made six distributions. These distributions totaled $141.4 million. But, as discussed above, $37 million in checks either could not be delivered or were not presented for payment. Thus, net distributions totaled $104.3 million. Taxes and administrative costs totaling $13.2 million reduced the residual to $159.8 million ($277.3 mil - $104.3 mil - $13.2 mil = $159.8 mil). The civil penalty component of the distribution funds was $89.4 million, which can be deemed to have earned approximately $13.7 million in interest, for a total of approximately $103.1 million. The residual tied to the disgorgement amount can therefore be deemed to be $56.7 million.

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[2] Heffler took several steps to check addresses in order to locate injured customers, including using the U.S. Postal Service's "National Change of Address" service. If a check was returned to Heffler without forwarding information, Heffler utilized a second locator service to obtain updated address information. Heffler indicated that this locator service has a success rate similar to many other locator services, including locator services that are more expensive.

After the sixth and final distribution, we stated that Heffler would begin the process of closing out the distribution fund. We also noted that Heffler had proposed that the remaining funds should be transferred to the U.S. Treasury. *See* Exchange Act Rel. No. 60402 (July 30, 2009). We then sought public comment "on the use of the Remaining Funds," including the proposal to transfer the residual to the Treasury. The Commission received such comments from Empire, Fleet, Van der Moolen Holdings, N.V. ("VDM"), CalPERS, Independent Asset Management and its principals, and two individuals, Robert J. Peacock and Ola Holmstrom.

## II. THE REMAINING FUNDS WILL BE DISTRIBUTED TO THE U.S. TREASURY.

After careful consideration of the commenters' views, we have decided to exercise our discretion to order that the remaining funds be transferred to the U.S. Treasury. The commenters oppose this course of action. They assert that the administrator has not adequately identified injured investors or distributed funds to injured investors that it did identify; they claim that the Commission's rules and the language of the settlement orders forbid distributing the residual to the Treasury; and they contend that the remaining funds should be used to compensate class members in the private class action, distributed *pro rata* to those who have already received funds, given to those who suffered derivative injuries, or placed in an escrow account to benefit the investors of VDM.

For the following reasons, and in light of the statutory and regulatory context described below, we disagree. Heffler undertook reasonable efforts to identify and distribute funds to injured investors, and we agree with Heffler that no other reasonable options for identification remain. We also agree that further efforts to distribute funds are not warranted. We do not agree with the commenters who assert that our rules or the language in the settlement orders bar the distribution of the remaining funds to the Treasury. And we are not persuaded that the alternatives presented by the commenters comport with the settlement orders, the Commission's rules, or the purposes underlying the establishment of Fair Funds in these proceedings.

### A. Statutory and regulatory background

The Securities Exchange Act of 1934 authorizes the Commission to enter an order of disgorgement in its administrative proceedings. Exchange Act Sections 21B(e) and 21C(e), 15 U.S.C. 78u-2(e) and 78u-3(e). Under these provisions, the Commission may order that the disgorgement amount, or some portion thereof, be returned to investors, but "there is no requirement that it do so." *Rules of Practice*, Exchange Act Rel. No. 35833 (June 9, 1995), 60 Fed. Reg. 32738, 32790 (June 23, 1995).

No such mandate exists because the "primary purpose of disgorgement . . . is to deter violations of the securities laws by depriving violators of their ill-gotten gains." *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir. 1997). "Although disgorged funds may often go to compensate securities fraud victims for their losses, such compensation is a distinctly secondary goal." *Id.*[3] Accordingly "the size of a disgorgement order need not be tied to the losses suffered

[3] *See also SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1097 (9th Cir. 2010) ("[T]he purpose of a disgorgement remedy is to prevent unjust enrichment and to make securities law violations unprofitable, not to compensate victims."); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) ("[T]he primary purpose of disgorgement is not to compensate

by defrauded investors," *Official Comm. of Unsecured Creditors of WorldCom v. SEC*, 467 F.3d 73, 81 (2d Cir. 2006) (internal quotation omitted), and "[t]he Commission has the power to require disgorgement of a wrong-doer's ill-gotten gains obtained by virtue of his or her securities law violation, regardless of whether particular investors suffered any damages." *Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission*, Exchange Act Rel. No. 49412 (Mar. 12, 2004), 69 Fed. Reg. 13166, 13168 (Mar. 19, 2004).

The Exchange Act, as amended by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, also authorizes the Commission to impose penalties in its administrative proceedings. Exchange Act Section 21B(a), 15 U.S.C. 78u-2(a). Like disgorgement, penalties serve as a deterrent, but unlike disgorgement, penalties punish individual violators for their wrongdoing. *Unsecured Creditors of WorldCom*, 467 F.3d at 81 (explaining that penalties "further the dual goals of punishment of the individual violator and deterrence of future violations") (internal quotation marks omitted). The purpose of ordering penalties is not compensation.

Before 2002, disgorgement could be used to compensate injured investors, but penalties could not. At that time, in judicial actions and administrative proceedings, disgorgement payments were sometimes placed into a fund to benefit injured investors. *See generally Rules of Practice*, Exchange Act Rel. No. 33163 (Nov. 5, 1993), 58 Fed. Reg. 61732, 61771, 1993 WL 468594 (Nov. 22, 1993); *SEC v. Certain Unknown Purchasers*, 817 F.2d 1018, 1021 (2d Cir. 1987). In 1995, the Commission promulgated rules regarding the procedures to be used with respect to disgorgement funds in administrative proceedings in order to formalize what had previously been an *ad hoc* process. *See* Exchange Act Rel. No. 33163, 58 Fed. Reg. at 61732, 1993 WL 468594, at *2; Exchange Act Rel. No. 35833, 60 Fed. Reg. at 32789 ("The rules relating to disgorgement are based on the Commission's experience in judicial actions involving disgorgement."). At that time, however, civil penalties were payable only to the U.S. Treasury and were unavailable to injured investors. *Unsecured Creditors of WorldCom*, 467 F.3d at 82.

Section 308(a) of the Sarbanes-Oxley Act of 2002 gave the Commission added flexibility with regard to penalties. The provision afforded the Commission the option to distribute civil penalties to defrauded investors. Section 308(a) states:

> "If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 78c(a)(47) of this title) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and

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investors."); *In the Matter of David Henry Disraeli and Lifeplan Assoc.*, Exchange Act Rel. No. 57027, 2007 WL 4481515, at *18 (Dec. 21, 2007) ("The primary purpose of disgorgement is not to refund others for losses suffered but rather 'to deprive the wrongdoer of his ill-gotten gain.'"), *aff'd*, 334 Fed. Appx. 334 (D.C. Cir. 2009), *cert. denied*, 130 S. Ct. 1914 (2010).

> become part of the disgorgement fund for the benefit of the victims of such violation."

15 U.S.C. 7246(a) (2002). Section 308 provided "the SEC with flexibility by permitting it to distribute civil penalties among defrauded investors" if it so chose. *Unsecured Creditors of WorldCom*, 467 F.3d at 83. Section 308 is permissive; "the SEC is not required to distribute Fair Fund proceeds to injured investors," and "the decision remains in the hands of the SEC whether to distribute civil penalties to victims *at all*." *Id.* (emphasis in original).

In 2004, we amended the 1995 rules to accommodate our new authority under Sarbanes-Oxley. Among other things, the rules permit Fair Fund plans to "provide for payment of funds into a court registry or to a court-appointed receiver in any case pending in federal or state court against a respondent or any other person based upon a complaint alleging violations arising from the same or substantially similar facts as those alleged in the Commission's order instituting proceedings." 17 C.F.R. 201.1102(a). Moreover, the rules state, as they did in 1995, that "[w]hen, in the opinion of the Commission or the hearing officer, the cost of administering a plan of disgorgement relative to the value of the available disgorgement funds and the number of potential claimants would not justify distribution of the disgorgement funds to injured investors, the plan may provide that the disgorgement funds and any civil penalty shall be paid directly to the general fund of the United States Treasury." 17 C.F.R. 201.1102(b).

In our 2004 adopting release, we stressed that disgorgement and penalties need not always be distributed to investors. We explained that in some instances, "the Commission may conclude that it is in the public interest to impose a civil money penalty and order disgorgement even though the relative value of the ill-gotten gains and the number of potential claimants would result in high administrative costs and de minimis distributions to individual investors." 69 Fed. Reg. at 13168. Under these circumstances, we explained that we "will not create a Fair Fund and will continue [our] practice of ordering that the disgorgement and civil penalty amount be paid directly to the United States Treasury." *Id.*; *see also id.* at 13173 (stating that the rule allows "monies that otherwise would go into a Fair Fund to be paid to the Treasury" even though that comes "at a cost to victims who might have received a minimal payment from a Fair Fund.").

### B. The administrator made reasonable efforts to identify injured investors and distribute funds to them.

Two commenters assert that the fund administrator failed to make adequate efforts to identify injured customers and to distribute the money to those it did identify. Empire claims that Heffler failed to identify injured customers, including Empire, either through "indifference or incompetence (or some other unknown reason)." Empire Letter at 4. CalPERS asserts that the administrator has not made sufficient efforts to identify injured customers and states that there are a number of "time-tested methods" that could still be used to identify injured customers, although it does not specify what those methods are. CalPERS Letter at 5.[4]

[4] Although CalPERS does not identify in its letter the "time-tested methods" that could still be used to identify injured customers, CalPERS lawyers have suggested to the Commission staff that notices could be published in newspapers soliciting injured customers to submit claims. Such notices would be wholly inappropriate and ineffective in a case such as this one. Because customers do not see order flow, they cannot know what other orders have been placed on the

As our factual findings demonstrate, Heffler engaged in a painstaking process to identify, and distribute disgorgement to, harmed investors. Heffler contacted over seven thousand entities to identify harmed customers associated with over two million transactions. After calculating each investor's harm and adding interest, Heffler distributed over 500,000 checks to the identified investors. Although Heffler was unable to identify all of the injured customers and was unable to locate some of those it did identify, this hardly indicates any "indifference or incompetence" on Heffler's part. The problems Heffler encountered were generally due to the state of the records and the passage of time. We conclude that the efforts made by Heffler were reasonable and appropriate and that further efforts to identify previously unidentified investors whose transactions were the subject of the settlement orders would not be reasonable or appropriate under the circumstances here. We further conclude that Heffler has taken adequate steps to ensure that funds were distributed to identified investors. Heffler has served as a claims or fund administrator in over 500 matters, and has handled securities cases since 1974. Based on its long experience administering funds and the particular facts of this case, Heffler has concluded that it has exhausted reasonable efforts to locate injured investors and that further efforts are unlikely to be fruitful.[5] We agree.

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NYSE or the times those orders are received, nor do they know when a specialist enters a proprietary order. As a result, no customer could ever know whether its order had been traded ahead of or interpositioned. The only way to establish such activity is to look at the NYSE data that included all orders and the times they were entered.

[5] Commissioner Paredes, in a dissent, states that, before the funds are transferred to the Treasury, further efforts should be made to reach injured investors. In particular, Commissioner Paredes proposes that additional efforts be made to locate certain investors whose checks were returned as undeliverable, and to have certain checks that were not cashed reissued to injured investors. We have considered these additional efforts and believe that on the facts of this case, and based on the conclusions reached by Heffler, an experienced fund administrator, further steps need not be taken. For example, Heffler has advised us that hiring an additional locator service for undeliverable checks would duplicate prior efforts and would not necessarily result in locating any significant number of additional investors. Similarly, based upon Heffler's experience, we question whether reissuing checks to injured investors would produce meaningful results. As we noted, Heffler sent a follow-up letter to the recipient of any outstanding check in an amount of \$500 or more that was not returned to Heffler as undeliverable but that remained uncashed for more than 90 days. Less than 10 percent of these customers subsequently cashed their checks. In light of this very low response rate, we agree with Heffler's conclusion that "[t]he time, effort and money that would be expended for further attempts at distribution are not warranted." April 14, 2011 Letter from Robert Bertino, Heffler, Radetich & Saitta L.L.P. at 6. While we recognize that reasonable persons can differ about whether it is appropriate to transfer the remaining funds to the Treasury without further efforts, this is the sort of judgment that necessarily involves an exercise of discretion. We conclude, in the exercise of discretion, that the transfer is appropriate at this time.

### C. The Commission's rules do not bar distribution of the remaining funds to the U.S. Treasury.

Three commenters assert that the Commission's rules prohibit the Commission from distributing the remaining funds to the U.S. Treasury. One commenter also argues that such a distribution is inconsistent with the settlement orders. We disagree.

#### 1. *Rule 1102(b) does not bar distributing the remaining funds to the U.S. Treasury.*

Empire asserts that if there are "any plausible injury claims that have no[t] been fully satisfied, the Remaining Funds should not be distributed to *anyone* other than injured investors—and certainly not to the U.S. Treasury." Empire Letter at 9. In support, Empire cites Commission Rule 1102(b), 17 C.F.R. 201.1102(b). *Id.* CalPERS also contends that Rule 1102(b) bars distribution of the remaining funds to the U.S. Treasury. CalPERS Letter at 1–2. In particular, CalPERS asserts that disbursement to the Treasury is improper because "the value of remaining funds far exceeds any cost of administering the plan of disgorgement." Fleet makes the same argument on behalf of the specialist firms. Fleet Letter at 2 ("[T]he Commission cannot satisfy the standards set forth in § 201.1102(b) to permit transfer to the Treasury given the present circumstances.").

We do not agree with this interpretation. Instead, as demonstrated below, we conclude that, by its terms, Rule 1102(b) does not apply to the distribution of residual funds. While the rule confirms that the Commission need not always require plan administrators to propose a plan of administration and distribution of monies to investors, the rule does not address or otherwise limit how residual funds in an administered plan may be distributed. Thus, the rule is silent as to what the Commission may do with residual funds after an administrator administers a fund, distributes monies to investors, and exhausts reasonable efforts to identify additional injured investors.

Rule 1102(b) provides that when the Commission determines that the cost of administering a plan of disgorgement relative to the value of the available disgorgement funds and the number of potential claimants would not justify distribution of the funds to injured investors, the Commission may approve a plan providing that disgorgement funds (and any civil penalty) be paid directly to the U.S. Treasury. The rule thus authorizes the Commission to approve a plan that pays disgorgement and civil penalty amounts directly to the Treasury instead of requiring an administrator to pay them to investors. The rule makes clear that the Commission has the option to approve sending disgorgement and penalties to the Treasury when it appears that the costs of administering a fund will outweigh the benefit to injured investors, such as when there are thousands of potential claimants and a small amount of disgorgement.

Therefore, Rule 1102(b) expands the options available to the Commission; it does not restrict them. Indeed, the rule uses discretionary terms ("may") to authorize the Commission to approve a plan calling for payment of disgorgement and monetary penalties to the Treasury in lieu of making any distribution to investors. The rule in no way limits the Commission's discretion to order paying a residual to the Treasury after an administrator has exhausted reasonable efforts to return the funds to injured investors.

Moreover, even assuming Rule 1102(b) did somehow apply to and limit the Commission's authority regarding the residual of an administered fund, paying the remaining funds to the U.S. Treasury under the circumstances here best comports with the rule. The rule covers situations where distribution of the disgorgement funds is not justified because the costs outweigh the benefits. In this context, where an administrator has, for more than five years, reasonably endeavored to identify, and distribute funds to, injured investors and, in the process, exhausted reasonable means of doing so—such that the benefits of continued efforts are likely to be negligible, or nonexistent—Rule 1102(b) supports distributing the remainder of the money to the U.S. Treasury.[6]

2. *The settlement orders do not bar paying the remaining funds to the U.S. Treasury.*

Fleet contends that distributing the remaining funds to the class, instead of the U.S. Treasury, is compelled by the settlement orders. Fleet writes that "so long as there is some use that will benefit investors, the Settlement Orders do not provide for any Remaining Funds to be turned over to the Treasury, and instead compel that they be made available for the benefit of investors such as those that are the subject of the Private Action." Fleet Letter at 2.

We do not agree. The settlement orders provide that the Commission "shall determine the appropriate use for the benefit of investors of any funds left in the Distribution Fund." Immediately following is the statement that: "Under no circumstances shall any part of the Distribution Fund be returned to [the Specialist Firms]." *E.g.*, Exchange Act Rel. No. 49498, at ¶ IV.E, 2004 WL 626586, at *12 (Mar. 30, 2004). Whether funds can, in fact, be appropriately used to benefit investors is a discretionary determination. As we have concluded, further efforts to distribute the funds to harmed investors are not warranted. The only remaining option for compensating harmed investors that bears careful consideration is that of directing the funds to the district court conducting the class action. As we explain in more detail below, however, on balance, we find that distributing the remaining funds to investors in the class would conflict with the orders' intent not to benefit the firms (as it expressly instructs that no part of the distribution funds may be returned to the firms).

### D. Distributing the remaining funds to the U.S. Treasury is more appropriate than the commenters' suggested alternatives.

Having determined that we are not prohibited from sending the remaining funds to the Treasury, we nevertheless consider whether we should exercise our discretion to order that they go elsewhere. The commenters suggest several alternative destinations for the remaining funds. Instead of paying the money to the Treasury, they contend, we should (1) make it available for the benefit of the investor class in the private class action; (2) distribute it *pro rata* to those persons who previously received money after being identified as injured investors; (3) give it to persons who suffered derivative injuries collateral to the primary injury covered by the settlement orders; and (4) with regard to the remaining funds attributable to the disgorgement and penalties paid by VDMS, one of the specialist firms, place it in an escrow account in The Netherlands.

[6] *See also* 69 Fed. Reg. at 13168 ("Where there are no identifiable victims of a violation, the Commission will continue to require that any disgorgement and civil money penalty amounts be paid to the United States Treasury.").

For the reasons explained below, we reject these alternatives and decide to exercise our discretion to distribute the entire residual to the U.S. Treasury.

1. *Distribution for the benefit of investors involved in the private class action.*

Two commenters suggest that the remaining funds be directed to the Southern District of New York to benefit the investors who have asserted claims against the specialist firms in the pending class action. Fleet, writing on behalf of the specialist firms, points out that the Commission's rules "expressly contemplate making the Remaining Funds available for the benefit of investors covered by the Private Action." Fleet Letter at 2. Fleet cites Rule 1102(a), which states that "a plan for the administration of a Fair Fund or a disgorgement fund may provide for payment of funds into a court registry or to a court-appointed receiver in any case pending in federal or state court against a respondent or any other person based upon a complaint alleging violations arising from the same or substantially similar facts as those alleged in the Commission's order instituting proceedings." 17 C.F.R. 201.1102(a).

We note at the outset that Rule 1102(a) is permissive, not mandatory. It authorizes the Commission, in its discretion, to provide for payment of funds into a private action pending in federal court. We did not exercise our discretion to authorize such a distribution when we approved the administrator's plan, and we do not exercise our discretion to order such a distribution now. Although the violations at issue in the class action arose out of similar misconduct to that in the Commission's settlements, and although Rule 1102(a) allows the use of funds in class actions arising from "substantially similar facts," we think a distribution to the class under the circumstances of this case would undermine the settlements we reached with the firms because it would indirectly return settlement funds to the firms. In accordance with the terms of the class certification, the violative transactions that are at issue in the class action are different violations than those that formed the basis of the Commission's settlements. To the extent that such violations can be proved, they give rise to separate and distinct liabilities for the specialist firms. The settlement orders state expressly that "[u]nder no circumstances shall any part of the Distribution Fund be returned" to the specialist firms. If the Commission distributed the remaining funds into a court registry for the benefit of investors litigating the class action, the Commission would reduce the specialist firms' liability in that action, indirectly accomplishing what the settlement orders strictly forbid. *See SEC v. Bear, Stearns & Co.*, 626 F. Supp. 2d 402, 417 (S.D.N.Y. 2009) ("If the undistributed funds were used to settle related litigations . . . some investors would receive compensation for injuries similar to those that were to be compensated by the Distribution Funds. However, Defendants would benefit from not having to pay those settlements with their own money," which would violate the terms of the settlement "by, in effect, returning funds to the Defendants for use to settle other matters.").

Empire also recommends distributing the remaining funds to investors involved in the class action, but its reasoning differs. Empire claims in its letter that the violative transactions identified in the settlement orders "were a fraction of the unlawful proprietary trades executed by the Specialist Firms from 1999 to 2003" (Empire Letter at 5), and Empire suggests that the remaining funds be used to compensate investors who were injured in transactions not covered by the settlements (Empire Letter at 8, 13 n.5).

The Commission does not agree with this suggestion, which involves upsetting the terms of the settlements reached between the Commission and the specialist firms. In essence, Empire is arguing that transactions that were specifically excluded from the Commission's settlements (and that formed the basis for certifying the class) should have been included in the settlements, and therefore that the customers connected to those transactions should now be compensated using settlement funds. In reaching the settlements, the Commission staff used an NYSE exception report that reasonably took into account system lags and the possibility of oral executions in determining what constituted a violation. Had the Commission included other transactions as part of the settlements, the terms of the settlements would have been different. The Commission will not revisit the settlements seven years after approving them.

Second, and related, it bears repeating that the transactions at issue in the private class action are distinct from the transactions at issue in the settlement orders. Use of the remaining funds to remedy the violations at issue in the private class action would necessarily be inconsistent with the terms of the settlement orders, which cover only a specific group of transactions. *See In re NYSE Specialists Sec. Litig.*, 260 F.R.D. at 60 (noting that the court previously held that "no customer could recover with respect to trades already covered by the Specialists Firms' regulatory settlements [with the Commission])." Indeed, in rebutting the specialist firms' argument that the class action should be dismissed because victory in the class action would result in an impermissible double recovery for the plaintiffs, Empire and CalPERS successfully contended that there was no duplication. *In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d at 308 ("The Plaintiffs argue that the alleged fraudulent and manipulative scheme at issue in this action exceeds the conduct uncovered in the SEC's investigation.").

Moreover, as noted above, using the remaining funds to benefit investors harmed by transactions that are specifically not covered by the settlement orders, and thus not covered by the distribution funds created pursuant to those orders, would benefit the wrongdoers in contravention of the settlement orders. Applying the remaining funds to cover liabilities in the class action would, at least indirectly, return a significant portion of the distribution funds to the specialist firms. *Bear, Stearns*, 626 F. Supp. 2d at 417.

Finally, we note that apart from the reasons for transferring the entirety of the residual to the Treasury, discussed above, we would in any event exercise our discretion to transfer to the Treasury, at a minimum, $89.4 million—the amount we ordered paid as penalties by the specialist firms (plus proportional interest thereon)—because we included a provision in each settled order[7] that "prevents the use of [the specialist firms'] civil penalty payments to offset

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[7] This provision states:

> Regardless of any such Fair Fund distribution, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that it shall not, in any Related Investor Action, benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor in this proceeding that is proportionately attributable to the civil penalty paid by Respondent ("Penalty Offset"). If the court in any Related Investor Action grants such an offset or reduction, Respondent agrees that it shall, within 30 days after entry of a final order granting the offset or reduction, notify the Commission's counsel in this action

civil damages" in a related private action such as the pending class action. *See In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d at 311. Moreover, although we exercised our discretion at the outset of these proceedings to create a Fair Fund of disgorgement and penalties (as specified in Sarbanes-Oxley Section 308, "for the benefit of the victims of such violations"), in retrospect, we can conclude that the penalties would not have been needed to compensate identified investors for their identified losses from the violations addressed in the settlement orders. In this circumstance, it would be reasonable for us to exercise our discretion to transfer \$89.4 million (plus a proportionate amount of interest thereon) to the Treasury, since that amount would have gone there if it had not been added to the distribution funds.

2. *Pro rata distribution to previously identified injured investors.*

Empire submits that the Commission should "make a *pro rata* distribution of the Remaining Funds to the identified Injured Customers" instead of sending the funds to the U.S. Treasury. Empire Letter at 12. Empire appears to contemplate that the Commission would order Heffler to make another distribution of checks to those customers who have already received them. Underpinning Empire's comment are the assertions that there is no way to know whether Empire, or any other identified customer, "received reimbursement anywhere near 100% of its actual losses" and that the "Commission did not attempt to, or purport to, reimburse customers for 100% of the losses caused by the Specialist Firm's illegal proprietary trading." *Id.*

The Commission disagrees with these assertions. The Commission's settlements in this case were based on specifically identified violative transactions and the amount of disgorgement was based on clearly identifiable and measurable customer harm. As a result, the injured customers who were linked to specific violative transactions and who cashed their distribution checks have been fully compensated for their losses connected to those transactions, including "pre- and post-judgment" interest. Of course, it is possible that some customers who were fully compensated for their losses with respect to a particular transaction may have also suffered a loss with respect to another transaction that was part of the settlement, but where, for one reason or another, the customer could not be identified as linked to the loss. But this does not change matters because there is no requirement that a plan administrator compensate any person for losses that cannot be substantiated. Indeed, Empire points to nothing more than supposition to support its assertion that neither it nor any other identified investor has received 100% of losses from transactions covered by the settlements.

We continue to be concerned that a *pro rata* distribution in this case would give an underserved windfall to the injured customers who already received payment. *See* Exchange Act Rel. No. 53823, 2006 WL 1358131, at * 7. There are funds remaining in the distribution fund not simply because some investors were not identified but also because: substantial penalties were included in the fund; identified injured investors could not be located after reasonable effort; identified injured investors who had been located failed to present the checks that they

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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 against Respondent in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order in this proceeding.

received for payment; and the fund earned a sizable amount of interest. Therefore, redistributing the entirety of these funds *pro rata* to those who already received money necessarily would give those injured investors a premium over their losses. This would not further the purposes of creating the distribution funds. Rather, it would provide an undeserved reward to a subset of injured investors that could be identified because another, and different, subset of identified injured investors could not be located or failed to cash their distribution checks, because yet another subset of investors could not be identified and because the distribution funds earned sizable interest and contained significant penalty amounts.[8]

Empire also calls our attention to a number of Commission distribution plans where we have approved disbursements using a *pro rata* methodology, including plans purportedly distributing *pro rata* residual monies "without limitation to the actual injury suffered . . . ." Empire Letter at 11 n.3. Empire's letter states that the Commission in such cases has even allowed persons "who were not injured" to benefit in such distributions. *See* Empire Letter, Appendix B. Thus, Empire's comment implies that using the residual funds here to pay the previously identified customers would not be an undeserved (or even unusual) windfall.

While the Commission has approved plans that called for a *pro rata* distribution, including *pro rata* distributions of remaining funds, that does not mean that the Commission countenances windfalls. All of the plans cited by Empire involved injury over an extended period of time to mutual funds, *i.e.*, pooled investment vehicles in the form of registered investment companies, where the ownership structure of the mutual fund can and does change on a regular basis. Because the purpose of the distribution plans was to compensate, to the extent reasonable, the harm suffered by the mutual funds and, given the ownership structure of the mutual funds, the Commission sought, in these cases, to distribute funds to persons who were shareholders at the time of the misconduct. In virtually all such cases, however, it was not feasible or practicable to locate and compensate mutual fund shareholders who were injured at the time of the misconduct. As a result, the Commission considered and approved distributions, including residual distributions, allowing the injured mutual funds themselves to receive amounts that could not otherwise be distributed to underlying injured shareholders. These distributions did not, however, result in a windfall to any party.[9]

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[8] We again note that the plaintiffs in the class action represented to the district court that they would "ensure that there will be no double recovery for injured investors who recovered from the SEC's settlement." *In re NYSE Specialists Sec. Litig.*, 260 F.R.D at 81.

[9] For example, Empire cites to the residual distribution portion of the plan in *In the Matter of Janus Capital Management LLC* (*Janus*), Admin. Proc. File No. 3-11590, 2004 WL 1845502 (Aug. 18, 2004) (order instituting proceedings). *See* Exchange Act Rel. No. 57721 (Apr. 25, 2008) (order approving the *Janus* plan). The *Janus* plan, like other plans cited by Empire, involved distributions to mutual fund investors in connection with improper conduct involving the market timing of mutual funds. In *Janus,* where the respondent was the adviser to the mutual funds, the harm to the funds was two-fold: the funds suffered certain quantifiable costs as a result of the improper trading, and the funds were harmed as a result of paying advisory fees to the respondent adviser, a fiduciary that was in breach of its fiduciary obligations. The *Janus* plan provided, in accordance with the terms of the Commission's settlement order, for "investors to

In contrast with distributions involving misconduct over time affecting pooled investment vehicles, the underlying misconduct at issue in the specialist firms' settlements disadvantaged millions of identifiable individual customer orders. The plan here recognized this and sought to compensate identified customers whose specifically identified trades were disadvantaged. The justification for a *pro rata* distribution in the market timing cases involving injuries to pooled investment vehicles thus is not present here. Moreover, we do not construe the decision to approve a *pro rata* distribution of a residual in other plans as establishing any rule or general practice that *pro rata* distributions are mandatory or necessarily even appropriate in other instances. Each plan responds to the unique facts of the proceeding that led to the creation of the distribution fund in the first instance. What is appropriate in one will not necessarily be appropriate in another.

In the Commission's view, the American Law Institute's Principles of the Law of Aggregate Litigation do not "mandat[e]" a *pro rata* distribution, as Empire claims. Empire Letter at 9–11. The ALI's views naturally do not bind the Commission, and, in any event, they are inapposite. The cited provision assumes that "funds generated through the aggregate prosecution of divisible claims are presumptively the property of class members." American Law Institute, Principles of the Law of Aggregate Litigation § 3.07, cmt. b (2010). It was only "[s]tarting from this vantage point" that the ALI concluded that a *pro rata* distribution to class members may be preferable to a *cy pres* distribution in some circumstances. *Id.* In a private class action, where individual plaintiffs aggregate their claims for redress, a *pro rata* distribution may indeed make sense because the class action seeks money as damages for the plaintiffs' losses. By contrast, as described above, disgorgement and penalties obtained by the Commission serve to deprive a wrongdoer of ill-gotten gains, sanction the wrongdoer, and deter future violations. In addition, as previously noted, the Commission is authorized, but not required, to distribute funds collected in its actions to harmed individuals, and may choose instead to remit the funds directly to the U.S. Treasury. In a Commission proceeding, the ALI presumption that funds to be distributed are the property of class members does not apply. *Cf. Bear, Stearns*, 626 F. Supp. 2d at 419 ("The original sources of the Distribution Funds were disgorgement and penalties. Those monies are the property of the Government.").

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receive, from the monies available for distribution in order of priority, (i) their proportionate share of losses suffered by the fund due to [the misconduct], and (ii) a proportionate share of advisory fees paid [to the respondent] by funds that suffered such losses during the period of [the respondent's misconduct]." *Janus,* 2004 WL 1845502, at *9. While Empire correctly notes that aggregate fund losses stemming directly from the improper market timing misconduct were calculated at approximately $21 million and the plan administrator was distributing $100 million, Empire neglects to consider that the Janus mutual funds also suffered additional injury because they paid advisory fees to the respondent adviser while the adviser was in breach of its fiduciary duty to the funds. When we created the Fair Fund in the *Janus* settlement, we determined it would be appropriate to return *both* a proportionate share of losses and a proportionate share of advisory fees to investors. Empire is incorrect in claiming that the *Janus* plan paid the affected investors and funds amounts in excess of the injury. While the *Janus* plan does not refer to the dollar amount of advisory fees paid, the fees paid were well in excess of the $79 million distributed as a return of fees.

Moreover, the ALI rejected the argument that a further *pro rata* distribution would constitute a windfall to the class members receiving the further distribution *based on the assumption* that "few settlements award 100 percent of a class member's loss" and that further distributions would therefore not likely result in more than 100% recovery. In this case, however, as described above, the injured customers who were linked to specific violative transactions and who cashed their distribution checks have obtained full compensation for their identified losses, plus "pre- and post-judgment" interest. Additionally, as stated above, given the size and composition of the distribution funds, including significant interest, penalties and amounts due to uncashed and returned checks, a *pro rata* distribution to those who have already received and cashed checks would necessarily result in a windfall. As a result, transfer of the residual to the Treasury is appropriate. *See Bear, Stearns*, 626 F. Supp. 2d at 407, 417, 419 (concluding that where funds in an SEC distribution fund exceeded the total substantiated claims, transfer of remaining funds to the U.S. Treasury was "[c]onsistent with the premise articulated by the American Law Institute").

3. *Distribution to those who suffered derivative injuries.*

Robert J. Peacock ("Peacock") is a trader who claims that he is a "special victim" of the specialists' misconduct. He claims a variety of injuries. In, for example, an attachment to a letter dated January 3, 2011, Peacock asserts that the Commission's collection of transaction trading fees was improper because the Commission failed to regulate the NYSE. January 2 Memorandum at 2–3. Had these fees not been collected, Peacock claims, his income would have increased by $125,000. Peacock seeks payment from the Commission of $510,000, which purportedly includes a reimbursement of his transaction fees plus interest and a $250,000 civil penalty against the Commission. *Id.* at 3. This claim for reimbursement and penalty to be paid by the Commission does not appear to seek money *from the distribution funds* and therefore is not responsive to the notice put out for comment. It is meritless in any event. The Commission is statutorily authorized to collect the transaction fees that Peacock mentions, and the assertion that the Commission failed to regulate the NYSE provides no basis for the return of such fees.

Throughout the period of plan administration, Peacock has also claimed that, as a result of the specialist misconduct, he lost income and business and that his losses should be satisfied out of the distribution funds. Notably, the Commission considered and rejected this claim when it approved the distribution plan here.[10] *See In the Matter of Bear Wagner Specialists LLC,* Exchange Act Rel. No. 53823, 2006 WL 1358131, at * 5–6 (May 17, 2006). We continue to

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[10] Two other commenters have also responded to the Commission's July 30 Notice by reiterating their requests that their derivative harms be compensated using distribution funds. *See* Independent Asset Management Letter, dated May 6, 2010, and Ola Holmstrom Letter, dated December 2, 2010. The distribution plan defines "Injured Customers" as "those individuals or entities whose trades were previously identified by the Commission staff and the NYSE in connection with the Specialist Firm Orders." We continue to reject these requests to compensate non-customer harm. *See* Exchange Act Rel. No. 53823, 2006 WL 1358131, at *5–*6 (rejecting "the suggestion that persons who suffered some loss that might be *derivatively connected* to the specialists' misconduct should be included in the class of injured customers.") (emphasis in original).

reject Peacock's assertion that he should be compensated for purported harms that are at most derivative of the specialist firms' securities law violations. Put simply, Peacock's claimed injuries are speculative and too far removed from the securities law violations at the heart of the settlement orders.

4. *Distribution to an escrow account for the benefit of investors in one of the specialist firms.*

Pursuant to its 2004 settlement order, VDMS, a majority-owned subsidiary of Van der Moolen Holdings, N.V. ("VDM"), paid in excess of $57 million in disgorgement and civil penalties. On August 10, 2009, VDM filed for bankruptcy protection in The Netherlands, where it was headquartered. Later that month, VDM's bankruptcy administrators submitted a comment letter to us requesting that remaining VDMS funds "be transferred to an escrow account in The Netherlands to be set up for a foundation that will be created to collect, manage and transfer the funds to the public shareholders and creditors of VDM." VDM Letter at 2. In that letter, VDM's administrators also suggested that distribution of the remaining funds should be postponed until The Netherlands' bankruptcy court and government ministries were afforded an opportunity to play a role in determining the destination of the portion of the remaining funds attributable to VDMS.

We reject these suggestions. First, in September 2009, the bankruptcy court declared VDM bankrupt and, later, VDM's assets were liquidated—the administrators having concluded that there "was nothing left to salvage."[11] Because the firm is no longer an ongoing concern, much of VDM's request is moot. Second, in any event, there has never been a legal basis for using VDMS's disgorgement and penalties to compensate VDM's shareholders or its creditors. The plan of distribution was structured, consistent with the settlement order, to compensate customers who were injured as a result of VDMS's unlawful trading practices. There is no legal basis for using those funds to compensate VDM's shareholders or its creditors. They were not the direct victims of VDMS's illegality, and while their investment in VDM may have suffered as a result of VDMS's illicit conduct, that fact does not transform them into the "investors" covered by the settlement order.

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[11] *Update 2-Court declares Van der Moolen bankrupt*, Reuters, Sept. 10, 2009, *available at* http://www.reuters.com/article/2009/09/10/vandermoolen-idUSLA18529920090910 (last visited Apr. 13, 2011).

## III.

In view of the foregoing, it is ORDERED that:

Following payment of any outstanding taxes, administrative fees and costs, the remaining funds in the distribution funds established in this matter shall be paid to the Securities and Exchange Commission for transfer to the U.S. Treasury.

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

Elizabeth M. Murphy
Secretary

By: Cathy Ahn
Deputy Secretary

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

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|---|---|
| **In the Matters of** | : |
| **Bear Wagner Specialists LLC** | : |
| **Admin. Proc. File No. 3-11445** | : |
| **Fleet Specialist, Inc.** | : |
| **Admin. Proc. File No. 3-11446** | : |
| **LaBranche & Co. LLC** | : |
| **Admin. Proc. File No. 3-11447** | : |
| **Spear, Leeds & Kellogg Specialists LLC** | : |
| **Admin. Proc. File No. 3-11448** | : |
| **Van der Moolen Specialists USA, LLC** | : |
| **Admin. Proc. File No. 3-11449** | : |
| **Performance Specialist Group LLC** | : |
| **Admin. Proc. File No. 3-11558** | : |
| **SIG Specialists, Inc.** | : |
| **Admin. Proc. File No. 3-11559** | : |
| **Respondents.** | : |

**Commissioner PAREDES, dissenting:**

I respectfully dissent from the Commission's order directing the remaining funds in this matter to be paid to the U.S. Treasury.

I do not believe it is appropriate at this time to return the total amount remaining in the fair fund to the U.S. Treasury. Because of the large sum of funds remaining in the fair fund, as well as other considerations, additional efforts should be made to distribute remaining funds to injured investors. For example, additional efforts should be made to locate certain investors whose checks were returned as undeliverable and certain checks that investors did not cash should be reissued to injured investors.

Chairman Schapiro
Commissioner Walter
not participating.

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64565 / May 27, 2011

Admin. Proc. File No. 3-13932

In the Matter of the Application of

RICHARD G. CODY
c/o Stephen Z. Frank, Esq.
P.O. Box 129
North Conway, NH 03860

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY PROCEEDINGS

**Unsuitable Trading**

**Misleading Documents Sent to Customers**

**Failure to Update Form U4**

Former registered representative of member firm of registered securities association made unsuitable recommendations, sent misleading account summaries and information, and failed to update timely his Form U4 to disclose two settlement agreements. *Held*, association's findings of violations and sanctions imposed are *sustained.*

APPEARANCES:

*Stephen Z. Frank, Esq.*, for Richard G. Cody.

*Marc Menchel, Alan Lawhead,* and *Michael J. Garawski*, for Financial Industry Regulatory Authority, Inc.

Appeal filed: June 9, 2010
Last brief received: October 27, 2010

I.

Richard G. Cody, formerly a registered representative associated with Leerink Swann & Co. ("Leerink" or the "Firm"), appeals from FINRA disciplinary action.[1] FINRA found that Cody recommended unsuitable trading in several customer accounts in violation of NASD Rules 2310 and 2110.[2] FINRA further found that Cody violated NASD Rule 2110 by sending customers misleading account summaries and information, and by failing to timely update his Uniform Application for Securities Industry Registration or Transfer Form ("Form U4") to disclose two settlement agreements. Based on these violations, FINRA suspended Cody from associating with any FINRA member firm for one year, fined him a total of $27,500, and assessed $8,711.25 in costs. We base our findings on an independent review of the record.

II.

Cody began working in the securities industry in 1996. After working for several other firms, he was associated with Leerink from December 2001 through May 2005. Beginning in May 2005, Cody was associated with GunnAllen Financial, Inc. ("GunnAllen"), which was then a broker-dealer and registered investment advisor.[3] The conduct at issue in this case began in 2003.

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1 On July 26, 2007, the Commission approved a proposed rule change that NASD filed seeking to amend its Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc. ("FINRA"), in connection with the consolidation of its member firm regulatory functions with NYSE Regulation, Inc. *See* Securities Exchange Act Rel. No. 56148 (July 26, 2007), 91 SEC Docket 522. Following the consolidation, FINRA began developing a new "Consolidated Rulebook" of FINRA Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See* Exchange Act Rel. No. 58643 (Sept. 25, 2008), 73 Fed. Reg. 57,174 (Oct. 1, 2008). FINRA's disciplinary action was instituted after the consolidation of NASD and NYSE, but the conduct at issue took place before the consolidated rules took effect. Accordingly, NASD conduct rules apply and references to FINRA herein include references to NASD.

2 NASD Rule 2310, sometimes referred to as the "suitability rule," requires that, in recommending the purchase, sale, or exchange of any security to a customer, a member must have reasonable grounds for believing that the recommendation is suitable for that customer based on the facts, if any, disclosed by the customer as to his other securities holdings and the customer's financial situation and needs. NASD Rule 2110 requires that members and associated persons "observe high standards of commercial honor and just and equitable principles of trade."

3 According to the Central Registration Depository available on FINRA's website, Cody continued to be associated with GunnAllen through March 2010, and was registered with another member firm as of April 21, 2011.

## A. The Customers

The conduct at issue in this case involves four of Cody's customers: Richard and Lenore DeSimone and James and Emma Bates (collectively, the "Customers").

### 1. Lenore and Richard DeSimone

The DeSimones began opening accounts with Cody in 1998, and transferred their accounts to Leerink when Cody moved there in December 2001. This case focuses on two of the DeSimones' Leerink accounts that together held well over half of the couple's assets: a joint account and Ms. DeSimone's individual retirement account ("IRA"), which included assets rolled over from another retirement account.

On the Leerink account opening forms, the DeSimones could choose from three options to describe their investment objectives: income, long-term growth, and short-term trading. The forms also listed four risk exposure options: low, moderate, speculation, and high risk. Ms. DeSimone's IRA form listed an objective of "long-term growth" and risk tolerance of "moderate," and at the hearing she described her risk tolerance as low to moderate. The joint account form listed an investment objective of "long-term growth" and risk exposure of "speculation." Ms. DeSimone testified that she had not "read the whole [document] through" before signing, and could not explain why the form listed a risk tolerance of speculation.[4] At the hearing, Cody admitted that the DeSimones were not interested in speculation as an "overall plan" or in Ms. DeSimone's account.

In February 2003, when the conduct at issue in this case began, Richard DeSimone was a 59 year old field engineer earning approximately $40-50,000 annually, and anticipating retirement from full-time employment. His wife, Lenore DeSimone, was 56 years old and had retired from a full-time position as an operations and purchasing manager in 2002. As part of her retirement package, Ms. DeSimone was receiving two years of payments totaling approximately $96,000 annually until August 2004. Before accepting this retirement package, the DeSimones explained to Cody that they would be relying on their retirement savings to cover their living expenses after the payments ended and asked for Cody's guidance in planning their investments in light of this goal.

The DeSimones had limited investment experience outside of their accounts with Cody. Ms. DeSimone had invested through a 401(k) account for approximately twenty years, and invested through an account with another broker-dealer for about six months. The DeSimones had also held savings and credit union accounts, savings bonds, and a small joint account with another broker-dealer.

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[4] When asked why the joint account form indicated an investment objective of speculation, Ms. DeSimone testified "I can't tell you why. Because I remember filling out forms, but the rest of it, I think Rich [Cody] filled out for us."

The DeSimones expressed an interest in bonds to Cody because they believed that bonds would help them meet their retirement income needs. Ms. DeSimone testified that they wanted "something . . . relatively safe, triple A, double A that type of bond," and requested bonds with maturity dates "somewhere around 10 years or so." Neither Ms. nor Mr. DeSimone had a sophisticated understanding of bond investing. For instance, they did not know that factors other than the stated coupon could affect the market value of bonds or that bond market values fluctuated. The DeSimones told Cody that they were "pretty naive about this whole market thing," were especially inexperienced in the bond market, and were relying on Cody to "watch our backs and make sure [our investments were] in our best interest."

Cody understood that the DeSimones were counting on their investment accounts to "generat[e] cash flow for living expenses," and that Ms. DeSimone's IRA "was earmarked . . . to draw off of" in retirement. He testified that "the number one priority" in the DeSimones' accounts "was to generate income and if it gr[e]w that much better." Cody knew that the DeSimones sought a fixed rate of return, and recommended a corporate bond investment strategy "because [corporate bonds] had highest yield."

**2. James and Emma Bates**

The DeSimones introduced their friends, James and Emma Bates, to Cody in January 2003. At the time, Mr. Bates was 69 years old and retired from his job in research and development, and Ms. Bates was 63 years old and retired from full-time work as a supervisor in an accounting department. Mr. Bates' prior investment experience included certificates of deposit, a joint account invested in individual stocks, bonds and REITs, and a former employer's 401(k) that included a choice of four funds. Mr. Bates did not have a sophisticated understanding of bond markets or investing strategies, and testified, "I don't know one bond from the other."

Mr. Bates opened an IRA at Leerink with an initial rollover contribution of $380,046, and hoped to generate $2,000 in monthly income from his account. The couple eventually deposited all of their savings in Leerink accounts with Cody, including in two IRAs for Ms. Bates. In Mr. Bates' account opening forms, he reported an investment objective of "income" and "low" tolerance for risk exposure. Consistent with these forms, Mr. Bates testified that he wanted to "maintain value" in the account but did not "expect it to grow as one would with a higher risk investment." Both Mr. and Ms. Bates discussed Mr. Bates' IRA with Cody, and Ms. Bates testified that the account "was our retirement, we needed to make sure it was safe." Cody understood Mr. Bates' retirement income goals for the account, and told Mr. Bates that "it would be no problem" to generate $2,000 in monthly income through bond investments. Cody understood that Mr. Bates "was drawing off his account right away" to cover living expenses, and did not want to deplete principal in his account.

## B. Cody Recommends Credit Suisse Securities

On February 6, 2003, less than a week after Mr. Bates opened his account, Cody invested $86,500, or approximately 23% of Mr. Bates' initial contribution, in Credit Suisse First Boston Mortgage Securities Corp. IndyMac Manufactured Housing Passthru (CUSIP 22540ABH0) (the "Credit Suisse Securities"). Weeks later, on February 25 and February 27, Cody made several purchases of the Credit Suisse Securities for the DeSimones' joint account, investing $31,725 (approximately 13%) of the account's $242,784 market value.

Originally issued in 1997 with a stated maturity of February 2028, the Credit Suisse Securities were collateralized by "[f]ixed rate manufactured housing installment sales contracts and installment loan agreements." The securities were divided into eleven classes, or tranches. The tranche that Cody recommended was eighth in order of priority, a $11.9 million mezzanine tranche with a 7.105% coupon, which was subordinated to approximately $117.8 million in the senior tranches.

Cody learned about the Credit Suisse Securities from Timothy Skelly, then a principal at Leerink. Skelly told Cody the issuer, the coupon, and the stated date of maturity. According to Cody's testimony, Skelly described the Credit Suisse Securities as "asset-backed securit[ies] supported by mortgages on homes." Cody testified:

> In a perfect situation, the way I understood it is that [customers] would get their coupon, and then they would also receive payments back that was essentially part of the principal that they invested. What [Skelly] told us with this particular bond and this type of security . . . more often than not, the prepayment happens long before the actual maturity date. And he told us on this particular investment, he believed the life of the bond to be six to seven years. Seven percent coupon, six to seven year life, trading at a discount, A rated.

He also indicated that Skelly provided "essentially the printout off of Bloomberg, essentially all the description said was the coupon, maturity date, rating of the security, and just . . . saying that IndyMac Bank was the bank that handled the finances."

Cody testified that he recommended the Credit Suisse Securities to his Customers within a day of this discussion with Skelly and without getting any further information. He testified that he relied on Skelly's recommendation, which he thought "[s]eemed like a pretty good idea" based on the coupon, expected maturity, trading price, and A rating.

From the dates of these purchases through early 2004, the Credit Suisse Securities were repeatedly downgraded, with the Fitch rating falling from A to CCC. The asking price also sharply declined from around $104 in February 2003 to around $41 by mid-February 2004. In February 2004, Cody began selling the Customers' holdings. Cody sold the DeSimones' holdings in February and April 2004, realizing a loss of $17,377, or about 55% of their initial investment.

He sold Mr. Bates' holdings in February, April, and May 2004, realizing a loss of $56,868, or about 66% of Mr. Bates' initial investment. Cody did not consult with either the Bateses or the DeSimones before he began executing these sales.

At the hearing, Cody admitted that he did not really understand the Credit Suisse Securities when he recommended the Customers' purchases. He conceded that he did not know or explain to the Customers which tranche he was recommending, what kind of assets collateralized the securities, or other factors that would affect the risks of his recommendation. Although Cody testified that he relied on the rating, he did not know that the securities had been downgraded by Fitch four months before his recommendations. He testified that he was not concerned about the securities' liquidity at the time, but did not know where they were traded or whether they were traded by "end accounts or . . . institutions." He admitted that he did not understand the Credit Suisse Securities when he sold them to the Customers. He testified: "At the time I sold it to them I didn't really look at [the Credit Suisse Securities] to be significantly different than any other type of bond; obviously I've learned quite a bit since then . . . "

**C. Cody Recommends Ahold, Calpine, and Royal Caribbean Bonds for Mr. Bates**

Later in 2003, Cody purchased three non-investment grade securities for Mr. Bates' account. In May 2003, he purchased Ahold Financial USA Inc. ("Ahold") bonds for approximately $46,923. The next month, he purchased Calpine Corp. ("Calpine") bonds for approximately $38,532, and Royal Caribbean Cruises, Ltd. ("Royal Caribbean") bonds for approximately $26,051. When purchased, the Ahold and Calpine bonds were rated "highly speculative" (B1) and the Royal Caribbean bonds were rated "speculative" (Ba2) by Moody's. By June 30, 2003, these three non-investment grade bonds accounted for $108,575, or approximately 23%, of the market value reflected on Mr. Bates' Leerink statement. Cody sold the Calpine bonds in July 2003, the Ahold bonds in September 2003, and the Royal Caribbean bonds in November 2003, realizing a total gain of approximately $2,077.

**D. Frequent Trading**

**1. Trading in Mr. Bates' Account**

From February 2003 through May 2004, Cody effected 108 trades in Mr. Bates' account. Although Leerink statements reported that Mr. Bates' account had a market value of less than $475,000 during each month of this period, Cody made sixty-nine purchases totaling approximately $1.7 million. Cody often funded these purchases by selling other securities from the account. None of the securities in Mr. Bates' account was held for the entire sixteen-month period, and most of the securities sold had been held for fewer than three months. In addition, he often made purchases and sales of the same or similar securities in quick succession.

For instance, Cody purchased $25,000 par value of Teco Energy Inc. ("Teco") 6.125% notes on March 19, 2003, and $75,000 par Teco 7.2% notes on April 1, 2003. On April 7, 2003, he both sold the 6.125% notes and purchased $25,000 par Teco 7.0% notes. On April 11, he sold the 7.2% notes. On April 24, he purchased $30,000 par 7.0% Teco notes. He sold $25,000 par 7.0% notes on May 6, 2003 and purchased $25,000 par 7.0% Teco notes on June 18. He sold the remaining 7.0% notes on July 24 and October 28.

According to the exhibits from the FINRA investigation, the purchases and sales in Mr. Bates' account during this period generated total commissions of more than $41,000, more than $17,000 of which went to Cody. The level of trading declined around May 2004, after Ms. Bates began pressing Cody to explain the account activity and values.

### 2. Trading in Ms. DeSimone's Account

From June 2003 through May 2004, Cody effected 140 trades in Ms. DeSimone's IRA. He made eighty-four purchases totaling more than $1.3 million during this period although the average market value reported for Ms. DeSimone's account on the Leerink statements was approximately $421,000. Cody generally sold other investments from the same account to fund these purchases. Only three fixed-income holdings were held for the entire period; these holdings had a total market value of $48,130 as of May 31, 2004, representing 11.7% of the $412,929 market value reflected on the corresponding Leerink statement. Many of the trades involved frequent purchases and sales of the same or similar securities in quick succession.

For example, on February 27, 2004 Cody purchased $25,000 par value Bally Total Fitness Holding ("Bally") 10.5% notes, and on March 5, he purchased another $25,000 par of the same notes. He sold these Bally notes on March 17 and March 18, 2004. On March 2, 2004, he purchased $15,000 par value of Merrill Lynch & Co. ("Merrill") medium-term zero-coupon notes. In two trades on March 8, he purchased another $45,000 par Merrill notes, and sold $20,000 par medium-term zero-coupon notes issued by another Merrill entity, Merrill Lynch & Co. Inc. ("Merrill Inc."). Eleven days later, on March 19, Cody purchased another $100,000 par of the Merrill medium-term zero-coupon notes.

According to exhibits from the FINRA investigation, the trades in Ms. DeSimone's account during this one-year period generated more than $36,000 in total commissions, more than $14,000 of which went to Cody. The FINRA examiner conducting the investigation calculated a commission to equity ratio of 8.7%, and a turnover ratio of 3.4.[5]

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[5] The 8.7% commission to equity ratio meant that Cody's recommendations would have had to generate 8.7% in gain to cover commissions and break even before generating any income for Ms. DeSimone. The turnover ratio of 3.4 reflected that the investments were replaced on average more than three times during the twelve-month period. FINRA declined to make findings regarding the performance of the accounts. *See also* infra the discussion of our *de novo* review of the evidence underlying these calculations in the text preceding note 43.

### 3. Control of Trading in Mr. Bates' and Ms. DeSimone's IRAs

The Customers had not signed documents giving Cody formal discretionary authority, but they allowed Cody to initiate and execute trades in their accounts before consulting them. Although Cody met with the Customers approximately six times a year and spoke with them several times a month, their discussions about individual trades almost always occurred after Cody executed them. Ms. DeSimone testified that the DeSimones orally agreed to allow Cody to make investments in their accounts before speaking with them.

The Customers testified that they trusted and relied on Cody to make appropriate investments. The DeSimones told Cody that they "were novices especially with the bond market," and Cody "assured [them] that he was looking out for [their] best interest." Ms. DeSimone testified that "95% of the time" Cody did not speak with her before making trades in her account, and that when she learned about the trades she thought they were "a done deal." Mr. Bates testified that he did not suggest investment ideas for his IRA, but rather wanted Cody to choose the investments. He did not recall Cody ever discussing trades with him before executing them. Mr. Bates learned about trades from confirmations, and Ms. DeSimone learned from spreadsheets that Cody prepared.

Cody testified at the hearing that he did not routinely discuss individual trades with the Customers in advance. He admitted that both Customers "relied upon and routinely followed his investment recommendations and deferred to his investment recommendations in almost all instances." When pressed to describe his discussions with the Customers, he admitted that their discussions were "not always specific to the particular bond that was bought or sold."

When the Customers asked Cody questions about the activity in their accounts, Cody offered reassurances and the Customers trusted these responses. For instance, in summer 2003, Mr. Bates asked Cody about the declining value of the Credit Suisse Securities on his statements and accepted Cody's assurance that the value reflected "an average of the bonds of Credit Suisse," but "not his particular bond." When Ms. DeSimone received a letter from Leerink asking for confirmation that she "underst[ood] the risks and benefits associated with investing in Collateralized Mortgage Obligations" in November 2003, she contacted Cody. He assured her that the letter was "just a formality from the front office. Don't worry about it. Everything is safe." Ms. DeSimone also asked Cody about the trading volume in her account in late 2003 or early 2004, but accepted his reply: "Don't worry about it. It is going to work out." When the Customers learned that they incurred significant losses upon the sales of the Credit Suisse Securities from their accounts in 2004, Cody assured them that the losses would be reimbursed.

## E. Account Spreadsheets and Activity Sheets

From 2003 until his departure from Leerink in May 2005, Cody created and sent twenty-four spreadsheets to the DeSimones and twenty-two spreadsheets to Mr. Bates. Cody testified that he used the Leerink statements to compile the spreadsheets. He told the Customers that these summaries, which he referred to as ladders or bond ladders, were meant to simplify the review of their accounts.

Cody's initial spreadsheets described the Customers' bond holdings, listing issuers, coupon rates, maturity dates, and coupon payments. For each bond, the spreadsheets listed a dollar amount as the "quantity" held, but did not define quantity; the quantity was the par value, not the market value, of each bond. The sheets included a total figure based on the sum of the listed bonds' par values.

In September 2003, Cody began supplementing the DeSimones' spreadsheets with information about their other holdings, including stocks, mutual funds, and cash. The information for these other investments included market values, but Cody continued to use the bond holdings' par values without stating that he was doing so. These spreadsheets listed a "Total Portfolio" value that added the cash and market values for the other investments to the par values for the bonds. The Total Portfolio amounts on spreadsheets between September 2003 and July 2004 exceeded the market values of the accounts on the Leerink statements by approximately 24% to 46%. In July 2004, Cody began disclosing the bonds' market values.

In November 2003, Cody began including on the spreadsheets for Mr. Bates his Leerink cash holdings and a total amount that added the cash amounts to the bond par values. He continued to do this until November 2004 when he started including market values for the bonds. The total account values listed on the spreadsheets between November 2003 and September 2004 exceeded the market values listed on the Leerink statements by approximately 8.7% to 36%.

Cody did not disclose that he was using par values for the bonds and did not explain the distinction between par values and market values to his Customers. Ms. DeSimone testified that she believed that the spreadsheets reflected the value of their "total liquid assets." When she had asked Cody about dollar amount discrepancies between the spreadsheets and the Leerink statements, he attributed those differences to the calculation dates and fluctuations in the market rather than the difference between par values and market values. He advised the DeSimones to "ignore the statements from Leerink." Mr. Bates also thought the spreadsheets Cody sent prior to September 2004 reflected the value of each bond and the total value of the account. He did not understand at the time he received those spreadsheets that they did not reflect market values.

Cody acknowledged during the hearing that, by adding together cash values, market values and par values, he created total amounts that were "neither a market value nor a maturity value," and that these amounts "do[n]'t mean anything when you're just looking at the thing as we are looking at it right now." He claimed that the Customers "understood [the amounts] not to be a market value or what they're totally worth . . . because the way the spreadsheets started in origin, which was specifically just the bond quantities. . . ."

Cody sent other inaccurate information to the Bateses. He sent Ms. Bates five different spreadsheets between March and August 2004, each indicating that her IRA held a "Merrill Lynch/6.5% bond" that was not then in her account. In May 2004, Cody sent Mr. and Ms. Bates "account activity sheets" which indicated that Electronic Data Systems ("EDS") bonds that he sold from their accounts had been called when, in fact, they had not been called.

## F. Cody's Form U4

After Cody left Leerink in May 2005, the DeSimones and the Bates spoke with Leerink managers about their accounts. The Customers raised concerns about Cody's recommendation of the Credit Suisse Securities, claimed that Cody had managed their accounts to maximize commissions, and alleged that the spreadsheets were misleading. Cody entered into settlement agreements with the Customers in August and September 2005, agreeing to pay $20,000 to the DeSimones and $56,000 to the Bateses. Although Cody was associated with GunnAllen at that time, he did not amend his Form U4 to reflect the settlements until September 2007.

## G. Procedural History

On January 14, 2008, the FINRA Department of Enforcement (the "Department") filed a complaint (the "Complaint") charging, among other things, that Cody engaged in unsuitable and excessive trading in the Bateses' and DeSimones' accounts, sent false or misleading statements to the Customers without prior approval from Leerink management, and failed to update his Form U4 to disclose his settlements with the Customers. The FINRA Hearing Panel (the "Hearing Panel") unanimously declined Cody's pre-hearing request to introduce expert testimony, finding that such testimony would not be "necessary or helpful to the Panel in resolving the issues in this proceeding." During his cross-examination of the FINRA examiner, Cody challenged the examiner's calculations and other exhibits submitted by the Department. The Hearing Panel declined to admit the Department's calculation of turnover rate and commission to equity ratio for Mr. Bates' account, but admitted turnover and commission to equity calculations for Ms. DeSimone's account and, for both accounts, admitted Leerink statements and schedules of trades and compensation.

After a five-day hearing, the Hearing Panel found that Cody violated the suitability rule by: (i) recommending the Credit Suisse Securities for Mr. Bates' IRA and the DeSimones' joint account; (ii) recommending non-investment grade bonds for Mr. Bates' IRA, and (iii) recommending and effecting quantitatively unsuitable (*i.e.*, excessive) trading in Mr. Bates' and Ms. DeSimone's IRAs. The Hearing Panel also found that Cody failed to observe high standards of commercial honor and just and equitable principles of trade by sending spreadsheets that included "misleading 'total portfolio' values," by failing to submit the spreadsheets for supervisory approval, and by failing to amend timely his Form U4 to disclose the settlements. The Hearing Panel, after hearing Mr. Bates, Ms. Bates, Ms. DeSimone and Cody testify, found the Customers to be "generally highly credible witnesses." It found that Cody's explanations for his actions were generally not credible. The Hearing Panel suspended Cody for three months, fined him a total of $27,500, and assessed costs.

On cross-appeals, the National Adjudicatory Council ("NAC") affirmed the Hearing Panel's findings regarding the unsuitability of Cody's trading recommendations and Cody's failure to timely update his Form U4 on May 10, 2010. The NAC reversed the Hearing Panel's finding that Cody failed to obtain prior supervisory approval for the correspondence he sent to the Customers, but affirmed its findings that the spreadsheets and activity sheets were materially misleading and were inconsistent with just and equitable principles of trade. Finding that "a stronger sanction is needed to remedy" Cody's violations of the suitability rule, the NAC increased the suspension to one year, while sustaining each of the fines imposed by the Hearing Panel. This appeal followed.

## III.

Exchange Act Section 19(e) provides that, in reviewing a disciplinary proceeding by a self-regulatory organization ("SRO"), we shall determine whether the associated person engaged in the conduct found by the SRO, whether the conduct violated the SRO rules at issue, and whether those rules were applied in a manner consistent with the purposes of the Exchange Act.[6] In conducting our *de novo* review, we apply a preponderance of the evidence standard to determine whether the record supports FINRA's findings that Cody's conduct violated its rules.[7]

### A. Suitability of Cody's Recommendations

Under NASD Rule 2310, a registered representative may recommend a purchase or sale of a security only if he or she "ha[s] reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Recommendations violate the rule if: (i) the representative's understanding of the investment is insufficient to establish a reasonable basis for making a recommendation; (ii) the representative inadequately assesses whether the recommendation is suitable for the "specific investor to whom the recommendation is directed;"[8] or (iii) the level of trading recommended by the representative is excessive in light of the customer's investment needs and objectives.[9] A violation of Rule 2310 constitutes a violation of Rule 2110, which requires registered representatives to "observe high standards of commercial honor and just and equitable principles of trade."[10]

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6 15 U.S.C. § 78s(e).

7 *See Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in NASD disciplinary proceeding).

8 *F.J. Kaufman & Co. of Va.*, 50 S.E.C. 164, 168-69 (1989).

9 NASD Interpretive Material 2310-2(b)(2).

10 *Perpetual Sec., Inc.*, Exchange Act Rel. No. 56613 (Oct. 4, 2007), 91 SEC Docket 2489, 2504 n.50; *see also Thomas W. Heath, III*, Exchange Act Rel. No. 59223 (Jan. 9, 2009), 94 SEC Docket 13242, 13247 n.8 ("It is well-established that a violation of another self-regulatory organization . . . or Commission rule or regulation will also automatically constitute a violation of the" NYSE rule regarding just and equitable principles of trade), *aff'd*, 586 F.3d 122 (2d Cir. 2009).

### 1. Credit Suisse Securities

A representative's recommendation carries the implicit representation that it was "responsibly made on the basis of actual knowledge and careful consideration."[11] Accordingly, the suitability rule requires that a representative ensure that he or she has an "adequate and reasonable" understanding of an investment before recommending it to customers.[12] This understanding must include the "potential risks and rewards"[13] and potential consequences of such recommendation.[14]

Cody did not have an adequate and reasonable basis for recommending the Credit Suisse Securities. By his own admission, Cody did not understand their features and "didn't really look at [them] to be significantly different than any other bond." He recommended them a short time after a limited discussion focused on yield, maturity date, and rating, and failed to evaluate other factors that could affect their value. For example, Cody failed to learn which tranche he was recommending or the associated subordination risks, details about the assets collateralizing the securities, or other factors that would affect the risks and liquidity of the securities he recommended. Although he testified that he relied on the credit rating, he did not inquire as to the ratings history, which included a recent downgrade. Cody's failure to gain an understanding of essential features of the Credit Suisse Securities rendered his recommendations unsuitable.

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11 *Kaufman*, 50 S.E.C at 168 n.18 (citing *Alexander Reid & Co., Inc.*, 40 S.E.C. 986, 990-91 (1962) ("A broker-dealer in his dealings with customers impliedly represents that his opinions and predictions respecting a [security] which he has undertaken to recommend are responsibly made on the basis of actual knowledge and careful consideration . . . . [I]t is not a sufficient excuse that a dealer personally believes the representation for which he has no adequate basis."); *Distribution by Broker-Dealers of Unregistered Securities*, Exchange Act Rel. No. 6721 (Feb. 2, 1962) ("[T]he making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for such recommendations which, in turn, requires that, as a prerequisite, he shall have made a reasonable investigation.")).

12 *Hanley v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969).

13 *Michael Frederick Siegel*, Exchange Act Rel. No. 58737 (Oct. 6, 2008), 94 SEC Docket 10501, 10513 (quoting *F.J. Kaufman & Co.*, 50 S.E.C. at 168 & n.18) (finding reasonable basis violation when representative did not read offering documents and, in any case, the documents included "conflicting or confusing information"), *petition denied in part and remanded in part*, 592 F.3d 147 (D.C. Cir. 2010). We reject Cody's argument that *Siegel* may be distinguished as a selling away case in which the representative's transactions were not monitored by his firm. Regardless of whether a firm monitors transactions by its representatives, the representatives are responsible for the suitability of the recommendations they make to their customers. *See infra* notes 19-20.

14 *Siegel*, 94 SEC Docket at 10513.

Cody claims that Commission precedent holds that his recommendation could not have been unsuitable unless there was something "unusual or special about [the Credit Suisse Securities] rendering [them] unsuitable for all retail investors."[15] Contrary to Cody's claim, we have held that a broker-dealer must have a reasonable and adequate basis for any recommendation he makes. This requirement, which we have referred to as the "reasonable basis test," is subsumed within the suitability rule because "a broker cannot determine whether a recommendation is suitable for a specific customer unless the broker understands the risks and rewards inherent in that recommendation."[16] Thus, a broker violates the suitability rule when he fails to conduct a reasonable investigation.

Cody asserts that both he and the DeSimones had prior experience with asset-backed securities (ABSs), and suggests that this experience was relevant to the suitability requirement. However, even assuming this to be true, Cody's or the DeSimones' experience with other ABSs in general does not establish a reasonable basis for Cody's recommendation of the Credit Suisse Securities.[17] Moreover, because Cody admits that he "didn't really look at [the Credit Suisse

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[15] Citing *Terry Wayne White*, 50 S.E.C. 211, 213 (1990) (explaining that "[a] broker cannot conclude that a recommendation is suitable for a *particular* customer unless he has a reasonable basis for believing that the recommendation could be suitable for at least *some* customers" (emphasis in original)); and *Kaufman*, 50 S.E.C. at 169 (stating that "a broker may violate the suitability rule if he fails so fundamentally to comprehend the consequences of his recommendation that such recommendation is unsuitable for any investor . . . "). These cases stand for the "well established" proposition that a "broker cannot recommend any security to a customer 'unless there is an adequate and reasonable basis for such recommendation,'" *White*, 50 S.E.C. at 212 (citing *Hanley*, 415 F.2d at 597) -- not Cody's claim that the suitability of a security for some customers excuses a representative's failure to establish an adequate and reasonable basis for a recommendation.

[16] *F.J. Kaufman & Co.*, 50 S.E.C. at 168 (explaining that reasonable basis "relates only to the particular *recommendation*, rather than to any particular *customer*" (emphasis in original); *see also id.* at 171 (explaining that the suitability rule imposes on a representative separate obligations to "know his security," "know his customer," and "know his transaction," including its implications and consequences for customers); *C. Gilman Johnston*, 42 S.E.C. 217, 219 (1964) (stating that the "reasonable grounds" suitability requirement "presupposes that a person recommending securities will be able to make such a determination. Otherwise, member firms could avoid the standard of conduct imposed by the rule by not training their salesmen"); NASD Notice to Members 01-23, Suitability Rule and Online Communications, 5 n.4 (describing customer-specific, reasonable basis, and excessive trading as separate types of suitability violations).

[17] *Larry Ira Klein*, 52 S.E.C. 1030, 1037 n.28 (1996) (rejecting claim that prior investments demonstrate suitability of a broker's later recommendations (citing *Douglas Jerome Hellie*, 50 S.E.C. 611, 613 (1991)); *Hanley*, 415 F.2d at 596 ("The fact that [the broker's]

Securities] to be significantly different than any other bond," his prior experience with ABSs did not factor into this recommendation.

Cody argues that he was entitled to rely on the information he obtained from Skelly about the security without conducting any further inquiry.[18] Skelly's familiarity with the Credit Suisse Securities, however, does not excuse Cody's violation; Cody, as the broker who recommended the securities, had an independent obligation to ensure that he understood them.[19] Even accepting Cody's testimony that he thought the Credit Suisse Securities "seemed like [they] fit what the client needed," a representative must have a reasonable understanding of the risks and benefits of the investment before he can recommend it.[20] Cody did not have such a reasonable understanding. Therefore, we find that his recommendation violated the suitability requirements under Rule 2310 and that, in turn, he engaged in conduct inconsistent with just and equitable principles of trade under Rule 2110.

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customers may be sophisticated and knowledgeable does not warrant a less stringent [investigation] standard.").

18 Cody argued before FINRA that he "took it upon himself to discuss the DeSimones and Bateses with Mr. Skelly and asked him to make the suitability determination." Neither his own testimony nor any other record evidence, however, supports this claim, and Cody also conceded before FINRA that "in the end suitability is his responsibility . . . ."

19 *See Dan King Brainard*, 47 S.E.C. 991, 996-97 (1983) (finding that "statements made by a salesman's superiors [are not] an adequate basis for representations made to investors"); *J. Stephen Stout*, 54 S.E.C. 888, 911-12 & n.53 (2000) (stating that a broker "cannot excuse his failure to conduct [a suitability] inquiry by claiming that he blindly relied on his firm's recommendations"); *Stephen Thorlief Rangen*, 52 S.E.C. 1304, 1309 (1997) ("Rangen cannot shift his responsibility as an investment counselor to his employer."); *Thomas Arthur Stewart*, 20 S.E.C. 196, 207 (1945) ("[A broker's] ignorance of his business would not excuse . . . an association member who undertakes to make recommendations with respect to securities transactions."); *cf. SEC v. Hansho*, 784 F. Supp. 1059, 1108 (S.D.N.Y. 1992) (noting that representatives "hold themselves out as professionals with specialized knowledge and skill to furnish guidance" and that "[y]outh or inexperience does not excuse a registered representative's duty to his clients" (citations omitted)).

20 *See Hanley*, 415 F.2d at 596 (stating that "a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein."); *see also Joseph Abbondante*, 58 S.E.C. 1082, 1106 n.62 (2006) (stating that "an honest belief in an issuer's prospects . . . does not in itself give one a reasonable basis for recommending the investment to others"); *Alexander Reid & Co.*, 40 S.E.C. at 990-91 (stating that "it is not a sufficient excuse that a dealer personally believes the representation for which he has no adequate basis").

**2. Non-Investment Grade Securities**

In addition to having a reasonable basis for making a recommendation, a registered representative's "recommendations must be consistent with his customer's best interests"[21] and be "tailor[ed] . . . to the customer's financial profile and investment objectives."[22] Generally, "risky investments are unsuitable recommendations for investors with relatively modest wealth and limited investment experience."[23] A broker recommending speculative investments also has "a duty to satisfy himself . . . that the customer understands and is willing to undertake the risks."[24]

We find that Cody's recommendations of the Ahold, Calpine, and Royal Carribean bonds were unsuitable and inconsistent with just and equitable principles of trade. Cody recommended that Mr. Bates make substantial investments in these bonds, which were rated speculative and highly speculative, even though he knew that Mr. Bates was retired, needed to preserve principle, requested low-risk investments, and needed immediate income for monthly withdrawals to cover living expenses. Cody's recommendations were inconsistent with Mr. Bates' financial profile and conservative investment objectives. Contrary to Cody's claim, the recommendations did not become suitable because he "monitored the investments carefully and sold the[m] when profitable." Suitability is determined at the time the recommendation is made; unsuitable recommendations do not become suitable if they later result in a profit.[25]

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[21] *Scott Epstein*, Exchange Act Rel. No. 59328 (Jan. 30, 2009), 95 SEC Docket 13833, 13851 n.24, *appeal filed*, No. 09-1550 (3d Cir. 2009); *Raghavan Sathianathan*, Exchange Act Rel. No. 54722 (Nov. 8, 2006), 89 SEC Docket 774, 782, *petition denied*, 304 F. App'x 883 (D.C. Cir. 2008) (unpublished); *Wendell D. Belden*, 56 S.E.C. 496, 503 (2003); *Daniel Richard Howard*, 55 S.E.C. 1096, 1100 (2002), *aff'd*, 77 F. App'x 2 (1st Cir. 2003) (unpublished).

[22] *F.J. Kaufman & Co.*, 50 S.E.C. at 168.

[23] *Luis Miguel Cespedes*, Exchange Act Rel. No. 59404 (Feb. 13, 2009), 95 SEC Docket 14272, 14281, *remanded on other grounds*, No. 09-1096 (D.C. Cir. 2009).

[24] *Donald T. Sheldon*, 51 S.E.C. 59, 74 n.59 (1992); *see also Henry James Faragalli*, 52 S.E.C. 1132, 1141 (1996); *Ward*, 56 S.E.C. at 259 (finding that broker improperly recommended a collateralized mortgage obligation investment "without also disclosing the associated risks"); NASD Notice to Members 96-21 ("Members are cautioned to take special care with respect to their suitability analyses where the securities involved are low-priced or speculative in nature.").

[25] *Klein*, 52 S.E.C. at 1037 n.29; *Laurie Jones Canady*, 54 S.E.C. 65, 81 (1999) ("The actual success or failure of [respondent's] purported trading strategy is irrelevant . . . . Unknown to her customers, [respondent's] 'trading strategy' generated high costs for her customers . . . and deviated grossly from these customers' stated conservative investment objectives."), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000); *Eugene J. Erdos*, 47 S.E.C. 985, 988 n.10 (1983), *aff'd*, 742 F.2d 507 (9th Cir. 1984); *cf. Janet Gurley Katz*, Exchange Act Rel. No. 61449 (Feb.1, 2010), 97 SEC Docket 25074, 25100 (finding that several of broker's

Cody attempts to justify his recommendations by arguing that Mr. Bates started withdrawing more than the $2,000 per month originally estimated. Cody contends that he needed to "be creative" to cover increased withdrawals and that investment grade bonds were not generating enough income to maintain principal. This argument fails for two reasons. First, the factual assertion is not supported by the record. Mr. Bates had not made a single withdrawal when Cody purchased the Ahold bonds in May 2003, and Cody purchased the Calpine and Royal Caribbean bonds the next month when Mr. Bates had made only one $2,500 withdrawal.

Second, an increase in withdrawals would not, without more, establish changed investment objectives or willingness to take on additional risk so as to render the recommendations suitable. Even if Mr. Bates were interested in pursuing higher returns through riskier investments, we have long held that a desire for yield does not justify recommendations that deviate from the customer's other investment objectives,[26] nor does it "relieve[] [the representative] from his duty to recommend only those trades suitable to" the customer's situation.[27] "[E]ven in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile."[28]

### 3. Excessive Trading

Excessive trading occurs when a registered representative has control over the trading in an account and the level of trading in that account is inconsistent with the customer's objectives and financial situation.[29] The requisite control may be established when the customer relies on the representative such that the representative controls the volume and frequency of

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"recommendations may have yielded some positive returns, but they still represented risky and costly investment choices given [the customers'] investment profiles"), *appeal filed*, No. 10-1068 (D.C. Cir. Mar. 26, 2010).

26 *Klein*, 52 S.E.C. at 1037.

27 *Rafael Pinchas*, 54 S.E.C. 331, 342 (1991); *see also Erdos*, 47 S.E.C. at 989; *Charles W. Eye*, 50 S.E.C. 655, 658 (1991) (finding that a customer's "request for a plan to increase . . . income was not a warrant to escalate risks unduly. If the only approach capable of producing the desired income involved significant dangers, [the broker] should have advised against it.").

28 *Jack H. Stein*, 56 S.E.C. 108, 113 (2003).

29 *Harry Gliksman*, 54 S.E.C. 471, 475 (1999), *aff'd*, 24 F. App'x 702 (9th Cir. 2001) (unpublished); *see also Rangen*, 52 S.E.C. at 1309 (finding that the representative violated the suitability rule by "us[ing] his influence over his customers' accounts to pursue an aggressive, short-term trading strategy that was inconsistent with his customers' investment objectives").

transactions.[30] A representative exercises *de facto* control if the customers "were not consulted, nor typically even made aware of, the particular trades executed in their account until well after the fact."[31]

The evidence establishes that Cody controlled the volume and frequency of trading in the Customer accounts. Both the Bateses and Ms. DeSimone testified that Cody routinely initiated and executed trades in their accounts before consulting or informing them and that they learned about these trades only after they had been completed. At the hearing Cody admitted that he did not tell the Customers about his intentions to buy or sell particular securities before, or even on the same day as, he made those trades.

A representative also exercises *de facto* control if the customer "relied heavily on and followed [the representative's] advice."[32] We have found *de facto* control when "consultations with [the customers] on investment choices were merely a formality"[33] because the customers did not have "sufficient understanding to make an independent evaluation of" the broker's recommendations.[34] Here, Cody maintained *de facto* control because the Customers did not

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30 *Clyde J. Bruff*, 53 S.E.C. 880, 883 (1993); *Rangen*, 52 S.E.C. at 1309; *John M. Reynolds*, 50 S.E.C. 805, 807 (1991).

31 *Frederick C. Heller*, 51 S.E.C. 275, 278 & n.7 (1993) (distinguishing cases involving pre-approval of recommendations); *see also Reynolds*, 50 S.E.C. at 807 (finding control where the broker did "not claim that [customers] suggested particular transactions on their own or approved particular transactions before their execution").

32 *Rangen*, 52 S.E.C. at 1309-10; *see also Gerald E. Donnelly*, 52 S.E.C. 600, 604 (1996) (finding control when customers "approved individual transactions simply on the basis of [the broker's] recommendations"); *Joseph J. Barbato*, 53 S.E.C. 1259, 1277 & 1272 (1999) (finding *de facto* control when the broker initiated all trading, and the customer "placed his trust and confidence in [the representative] and allowed him to decide what to buy or sell in the account," and "habitually followed [the representative's] recommendations").

33 *Michael David Sweeney*, 50 S.E.C. 761, 765-66 (1991) (finding control when customers "did not initiate the transactions in their accounts, nor did they fully understand the trading therein" and "were relying totally on the [brokers]"); *Bruff*, 53 S.E.C. at 883 (stating that "lack of sophistication with investing placed [customer] in a position where she had to rely on [the representative] for advice"); *Sandra K. Simpson*, 55 S.E.C. 766, 796 (2002) (finding *de facto* control established "either because the customer relied on her, or because the customer was incapable of controlling the account").

34 *Erdos*, 47 S.E.C. at 990; *Al Rizek*, 54 S.E.C. 261, 270 (1999) (finding *de facto* control when customers were "lacking in the degree of investor sophistication necessary to understand [their broker's trading] strategy and [were] unable to make any sort of independent evaluation of that strategy"); *cf. Follansbee v. Davis*, 681 F.2d 673, 676-77 (9th Cir. 1982) ("[T]he account may be in the broker's control if his customer is unable to evaluate his

independently evaluate his recommendations but rather acquiesced in his trades. Cody admitted throughout these proceedings that the Customers trusted him to guide their investment strategies and routinely followed his recommendations. Mr. Bates testified that he did not suggest investment ideas but rather trusted Cody to direct the investments in his account. Ms. DeSimone testified that she trusted Cody to select investments before consulting her, and to "watch our backs and make sure [our investments were] in our best interest."

Cody makes three arguments that he lacked control over the accounts. First, he asserts that the Customers had relevant prior investment experience, suggesting that they were sufficiently sophisticated to control their own accounts. The evidence establishes that the Customers had little if any experience evaluating individual bonds or short-term bond trading, and relied heavily on Cody's recommendations. Mr. Bates testified, "I don't know one bond from the other." The DeSimones told Cody that they "were novices especially with the bond market" and responded to a recommendation by stating "we are pretty naive about this whole market thing" and evaluated his recommendation by asking "Would you trust your parents in these investments?" After Cody assured them that he "wouldn't steer [them] wrong," the DeSimones accepted the recommendation.[35]

Second, Cody argues that the Customers' review of confirmations and statements demonstrates their control, but we have rejected claims that the receipt of such post-trade notice amounts to control over accounts.[36] Third, he claims that the Customers' questions demonstrated

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recommendations and to exercise an independent judgment."); *Carras v. Burns*, 516 F.2d 251, 258-89 (4th Cir. 1975) (noting that "control may be inferred from the broker-customer relationship when the customer lacks the ability to manage the account and must take the broker's word for what is happening" and "[t]he issue is whether or not the customer, based on the information available to him and his ability to interpret it, can independently evaluate his broker's suggestions").

[35] The Hearing Panel found the Customers' testimony to be generally highly credible and Cody's testimony not credible. The credibility determination of an initial fact finder is entitled to considerable weight and deference because it is based on hearing the witnesses' testimony and observing their demeanor. *See, e.g., Rita J. McConville*, 58 S.E.C. 596, 608 n.21 (2005), *petition denied*, 465 F.3d 780 (7th Cir. 2006). Such determinations generally "can be overcome only where the record contains substantial evidence for doing so." *Canady*, 54 S.E.C. at 78 (citing *Anthony Tricarico*, 51 S.E.C. 457, 460 (1993), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000)). We do not find that the record contains such evidence here.

[36] *See Sweeney*, 50 S.E.C. at 766 & n.17 (1991) (finding confirmations and monthly statements did not negate control because the customers were not "sufficiently knowledgeable to understand that the transactions in their accounts were excessive" when, for instance, customers did not know that the brokers made a commission on every trade or how the trading activity affected the value of their accounts); *Stein*, 56 S.E.C. at 119 n.31 (rejecting argument that customer was "estopped from objecting to his conduct because she was fully aware of his trading

active management of their accounts, but their reliance on his spreadsheets and their acceptance of vague and misleading responses to their questions confirms that they were, in fact, "unable to make any sort of independent evaluation of" Cody's trading in their accounts during the trading period.[37] Under these circumstances, we find that Cody exercised *de facto* control over Mr. Bates' and Ms. DeSimone's accounts.

Having established Cody's control, we next examine the level of trading in the accounts. Customer investment objectives and financial situation are the benchmarks for evaluating whether the level of trading in any account is appropriate.[38] Here, neither Mr. Bates nor Ms. DeSimone expressed interest in short-term or speculative trading in these accounts, which were to be used to fund retirement, demonstrating a need to protect principal and limit risk-taking. Yet Cody engaged in aggressive "in-and-out" trading, repeatedly purchasing bonds and then selling them after relatively short holding periods to purchase other securities.[39] Cody often effected multiple and overlapping trades in the same or similar securities within weeks, or even days, of one another. Such in-and-out trading is a "hallmark of excessive trading"[40] and "extremely difficult for a broker to justify."[41]

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activities" based on receipt of confirmations, periodic account statements and discussions of "trading philosophy and investment methods"); *cf. Karlen v. Friedman*, 688 F.2d 1193, 1200 (8th Cir. 1982) ("When a customer lacks the skill or experience to interpret confirmation slips, monthly statements or other such documents, courts have generally refused to find that they relieve a broker of liability for its misconduct."); *Katz*, 97 SEC Docket at 25103 ("[R]atification of a transaction after the fact does not establish that trades were authorized before being executed"); *William C. Piontek*, 57 S.E.C. 79, 92 (2003)(rejecting claim that "customers subsequently ratified . . . trades" in an unauthorized trading case and finding "after-the-fact acceptance of an unauthorized trade does not transform it into an authorized trade"); *Edgar B. Alacan*, 57 S.E.C. 715, 728 n.27 (2004) (finding that any delay in complaining about unauthorized trades "was a consequence of misplaced trust in [the representative], rather than approval of his actions").

37 *Rizek*, 54 S.E.C. at 270.

38 *Rangen*, 52 S.E.C. at 1309.

39 "The term 'in and out' trading denotes the sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities." *Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).

40 *Howard*, 55 S.E.C. at 1100-01.

41 *Pinchas*, 54 S.E.C. at 339 (*citing Costello*, 711 F.2d at 1369 n.9) (noting that in-and-out trading can, by itself, establish excessive trading).

Cody executed 108 trades over sixteen months in Mr. Bates' account, including sixty-nine purchases totaling approximately $1.7 million – more than three times the average market value of the account during this period. None of these securities was held for the entire period, and most of the sales involved securities held for fewer than three months. Although Ms. DeSimone's account had an average market value of less than $425,000, Cody executed 140 trades, including eighty-four purchases totaling more than $1.3 million, over the year at issue. Only three fixed-income securities were held for the entire period, representing 11.7% of the market value at the end of the twelve-month trading period, and investments were replaced on average more than three times during the period.

This aggressive short-term trading generated large commissions that were contrary to the Customers' interest in minimizing costs and preserving capital. Mr. Bates paid more than $41,000 in commissions during the same sixteen-month period he sought to earn approximately $32,000 in income. Ms. DeSimone paid more than $36,000 in commissions for twelve months of trading in her IRA. Her investments would have had to earn an 8.7% return just to cover these commissions and avoid net losses. Such a high break-even level suggests overly aggressive trading given Cody's understanding that Ms. DeSimone's "number one priority . . . . was to generate income" to cover living expenses during retirement.[42]

Cody argues that the finding of excessive trading was based on unreliable evidence. He asserts that the Hearing Panel's decision to exclude the FINRA examiner's turnover and commission-to-equity calculations for Mr. Bates' account (the "Bates Ratios") discredited all of the other calculations and trading evidence in the record. He also argues that the NAC improperly relied on such discredited evidence as the basis for its findings with respect to Ms. DeSimone's account.

The Hearing Panel excluded the Bates Ratios after Cody established that the calculations were based on a schedule that incorrectly transposed market values and purchase amounts from the monthly Leerink statements. Neither the Hearing Panel nor the NAC relied on either of these measures to determine whether there was excessive trading in Mr. Bates' account. The Hearing Panel considered the other objections Cody raised at the hearing, which focused on valuations on the Leerink statements and other purported inconsistencies between calculation schedules and the statements. Regarding the Leerink statements, the panel observed that, "while some of the valuations may appear questionable, Cody offered no evidence from other sources showing that the [Leerink statements] were incorrect." The Hearing Panel also "compar[ed] the schedules and the account statements" and found "that they appear consistent." The NAC similarly concluded that the FINRA examiner's calculations with respect to Ms. DeSimone's account "were reliable."

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42 FINRA did not make findings regarding whether the "alleged excessive trading in [Mr. Bates' or Ms. DeSimone's] IRAs generated losses;" the market value reflected on the Leerink statements for Ms. DeSimone's IRA during the trading period fell from $460,563.17 to $412,928.94.

In this appeal, Cody has not offered additional evidence of calculation or valuation errors or further support for his suggestion that errors in the calculation of the Bates Ratios were sufficiently egregious to compel us to disregard all of the other evidence. In our independent review of the evidence, we found certain potential discrepancies in the admitted exhibits that could affect the FINRA calculations. When read most favorably to Cody, the discrepancies could, for instance, reduce the number of trades in Mr. Bates' account from 109 to 108, reduce the total purchases in Ms. DeSimone's account from $1.43 million to $1.35 million, and reduce the turnover ratio in Ms. DeSimone's account from 3.40 to 3.21. We find that these adjusted figures are nevertheless consistent with a finding of excessive trading in both accounts given the Customers' conservative investment objectives and financial situations.[43]

Moreover, even if we were to disregard the trading evidence submitted by FINRA, the record still supports a finding of excessive trading. As we recognized in *Gerald E. Donnelly*, our assessment of whether trading is excessive "does not rest on any 'magical per annum percentage,' however calculated."[44] Other evidence confirms that Cody engaged in excessive trading given that the Customers were not interested in short-term or speculative trading. Cody himself submitted exhibits that reflected trading activity in the Customer accounts generally consistent with the Leerink statements and the exhibits prepared by the FINRA examiner. His exhibits confirm his aggressive short-term trading in both accounts, including numbers of trades and purchases as cited in this opinion, and the pattern of in-and-out trading and short holding periods.[45]

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[43] *See Donnelly*, 52 S.E.C. at 602 n.11 (noting respondent's acknowledgment that "an annualized turnover rate of between two and four percent is presumptive of churning"); *Stein*, 56 S.E.C. at 118 (noting that "turnover rates between three and five have triggered liability for excess trading"); *Donald A. Roche*, 53 S.E.C. 17, 21 (1997) (finding account with turnover rate of 3.3 was excessively traded for conservative investor); *Simpson*, 55 S.E.C. at 794 (finding excessive trading in account of elderly retiree with conservative investment objectives and annualized turnover rate of 2.1); *Stout*, 54 S.E.C. at 894 n.18 (noting expert testimony that, as a "rule of thumb," "a turnover rate of two may be considered suggestive of excessive trading for a conservative investor").

[44] 52 S.E.C. at 603; *see also Stein*, 56 S.E.C. at 117-18 (noting that "there is no single test for making an excessive trading determination").

[45] Contrary to Cody's arguments before the NAC, the Hearing Panel did not shift the burden of proof to Cody, and he was not disciplined for his failure to "articulate the reasons for" his trading. After the Department submitted evidence of violative conduct, the Hearing Panel offered Cody repeated opportunities to "articulate a rationale for his trading, either on an overall or trade-by-trade basis," but found that he was "unable to offer any specific colorable explanation." FINRA considered Cody's testimony before determining that the preponderance of the evidence established that he recommended and effected frequent trades, including short term and in-and-out trading, inconsistent with the Customers' investment objectives and financial

Cody also argues that FINRA used an inappropriately abbreviated timeframe to find excessive trading. He asserts that there must be a "drastic change" in trading strategy in order to justify a review of a trading period "less than the life of the account."[46] However, an excessive trading inquiry does not require "looking only at the full period that the broker managed the customer's account; rather it is appropriate for us also to review the trading done over a reasonably abbreviated portion of the entire period."[47] Here, the excessive trading took place over the sixteen months after Mr. Bates first opened his account, and twelve months in the DeSimones' account. Moreover, the trading periods under review end in May 2004 – around when Ms. Bates questioned the level of activity and expressly asked Cody to stop trading.[48]

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situations. *See Pinchas*, 54 S.E.C. at 339 (finding excessive trading when "nothing in the record reveals any justification for" a pattern of in-and-out trading in a customer account).

[46] Cody cites *Frederick C. Heller*, which found excessive trading based on turnover analysis of a portion of the life of a customer account, indicating that the "four and one-half month review period was appropriate because it [was] the period during which [the representative] implemented [a] drastic change in trading strategy, with [an] increased volume of trading." 51 S.E.C. at 279. However, *Heller* did not hold that such a drastic change in strategy was a prerequisite to limiting the period considered. In any case, Cody argues that, as in *Heller*, the trading in the Customer accounts during the periods at issue was not representative of the overall trading in the account.

[47] *Stein*, 56 S.E.C. at 118 n.30 (citing *Peter C. Bucchieri*, 52 S.E.C. 800, 805 (1996)); *see also Simpson*, 55 S.E.C. at 795 n.45 ("That the broker . . . managed to obey the securities laws at one time does not insulate her from liability.").

Cody also argues that his trading in Mr. Bates and Ms. DeSimone's IRAs was suitable when considered with the Customers' spouse and joint accounts. For example, Cody argues that his trading levels in these accounts were appropriate as part of a "family" plan, and that the absence of excessive trading charges in other accounts precludes finding excessive trading in these accounts. The evidence and testimony confirm that these accounts were treated as separate accounts by both the Customers and Cody, however, and we will not conflate the accounts for purposes of the excessive trading inquiry. *See, e.g., Heller*, 51 S.E.C. at 279 (declining to measure the trading activity "against the total assets for which [the respondent] was the registered representative"); *Bucchieri*, 52 S.E.C. at 806 (stating that "the assets by which the rate of activity is to be measured are those in the account, not other assets that the customer may possess").

[48] Cody argues that Mr. Bates' and Ms. DeSimone's accounts were profitable, suggesting that the trades were therefore suitable. We are not persuaded by Cody's calculation of trading returns, which offset the Customers' trading losses with the amounts paid to the Customers in the settlements. *See, e.g., Michael T. Studer*, 57 S.E.C. 1011, 1019 n.22 (2004) (noting that NASD net loss computation regarding a churned account excluded settlement payment amounts), *aff'd*, 148 F. App'x 58 (2d Cir. 2005). As noted, suitability is determined at the time of the recommendation. Profit is not a defense to a suitability violation. *See supra* note

Given the Customers' conservative investment objectives and financial situations, the control Cody exercised over the accounts, and the short-term nature of the trading, we find that Cody engaged in excessive trading in Mr. Bates' and Ms. DeSimone's accounts that violated the suitability rule and was inconsistent with just and equitable principles of trade.

## B. Other Conduct Inconsistent with Just and Equitable Principles of Trade

### 1. Account Spreadsheets and Activity Sheets

Material misstatements and misleading statements to a customer are inconsistent with just and equitable principles of trade.[49] In particular, we have found that "inaccurate and misleading account summaries and/or reports" fail to satisfy these principles.[50]

Cody does not dispute that the account summaries that he sent to the DeSimones and Mr. Bates included calculations of total account and total portfolio values that were materially misleading. Cody failed to disclose that the values reported for the bond holdings were par values. The Customers thought that the stated amounts were market values. By adding cash and market values to par values, Cody created totals that he admitted "do[n]'t mean anything when you're just looking at the thing as we are looking at it right now." These totals were particularly problematic because they overstated the account values by approximately 24% to 46% for the DeSimones, and by approximately 8.7% to 36% for Mr. Bates.

In addition, the Bateses' account activity statements inaccurately indicated that their EDS securities holdings were called, and spreadsheets for Ms. Bates inaccurately stated that she held specific bonds.[51] These misstatements were material to the Customers' efforts to understand the trading and market values of their accounts, and are not justified by Cody's claim that he sent this information in response to Customer questions. By sending his Customers these documents containing material misstatements, Cody engaged in conduct inconsistent with just and equitable principles of trade.

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25 and accompanying text.

49 *Katz*, 97 SEC Docket at 25097.

50 *Dan Adlai Druz*, 52 S.E.C. 416, 421-22 (1995), *aff'd*, 103 F.3d 112 (3d Cir. 1996) (table).

51 During the proceedings below, Cody made various attempts to avoid responsibility for the misleading nature of the statements. However, "[a]s a registered securities professional and the author of the [documents]," we hold Cody "responsible for [their] contents," and "reject [his] attempt[s] to shift responsibility . . . for the content of a document that he himself created." *Klein*, 52 S.E.C. at 1034 & 1035.

### 2. Form U4

It is undisputed that Cody failed to update timely his Form U4 to disclose the two Customer settlements. In so doing, he engaged in conduct inconsistent with just and equitable principles of trade. Registered representatives are required to keep a current and accurate Form U4 on file with FINRA at all times. The failure to update this form "undermines [FINRA]'s ability to carry out its self-regulatory functions,"[52] and frustrates attempts by customers "who are or may be interested in doing business with [the registered person]" from gathering "accurate disclosure information" about such person.[53] Accordingly, a failure to provide such updated disclosure is inconsistent with the just and equitable principles of trade to which every person associated with a FINRA member is held.[54] Among the information required to be disclosed at the time was any "investment-related, customer-initiated complaint" alleging "sales practice violations" if "the complaint was settled for an amount of $10,000 or more." The Form U4 was required to be updated within 30 days of such a settlement.

Before the Hearing Panel, Cody argued that a former Leerink compliance officer advised him that a Form U4 amendment was not required following the two Customer settlements and that he asked GunnAllen to amend the Form U4. However, a registered representative cannot shift responsibility for compliance requirements to his firm or supervisor.[55]

## IV.

Cody raises a number of procedural objections to the FINRA disciplinary action primarily related to the suitability violations. He argues that: (a) the investigation of his conduct was inadequate; (b) he was improperly denied the opportunity to present documentary evidence and testimony, including from an expert witness; (c) he was not given sufficient notice of the nature of the charged suitability violations regarding the Credit Suisse Securities; and (d) the disciplinary action was tainted by "bias" and "abuse of process." We evaluate these claims to determine whether FINRA met its Exchange Act obligations to apply a "fair procedure" and to

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52 *Richard J. Lanigan*, 52 S.E.C. 375, 378 (1995).

53 NASD Notice to Members Amendments to Section 4 of Schedule A to the NASD By-Laws, February 2004, available at http://www.complinet.com/file_store/pdf/rulebooks/0409ntm.pdf

54 *Scott Mathis*, Exchange Act Rel No. 61120 (Dec. 7, 2009), 97 SEC Docket 23228, 23235, *appeal filed*, No. 10-429 (2d Cir. Feb. 3, 2010).

55 *Guang Lu*, 58 S.E.C. 43, 56 (2005), *aff'd*, 179 F. App'x 702 (D.C. Cir. 2006) (unpublished); *Lanigan*, 52 S.E.C. at 378 n.13 ("Participants in the securities industry must take responsibility for compliance [with regulatory requirements] and cannot be excused for lack of knowledge, understanding, or appreciation of these requirements."); *see also infra* note 63.

"bring specific charges, notify [the charged person], and give him an opportunity to defend against, such charges."[56]

## A. FINRA Investigation

Cody argues that FINRA conducted a "grossly incomplete investigation" by, among other things, giving him insufficient notice that he was a target, not "attribut[ing] any validity to [his] response to the Wells notice," and not affording him a sufficient opportunity to respond to information gathered in the investigation. He also contends that FINRA was required to acquire additional documentation and investigative testimony before issuing the Complaint.

We reject these contentions. Section 15A(b)(8) of the Securities Exchange Act of 1934 requires SROs to provide a "fair procedure" in an adjudicatory proceeding. This statutory requirement does not extend to investigations.[57] For example, FINRA, as an SRO, is not required to provide a registered person "with actual notice of an investigation into [the registered person's] conduct."[58] The purpose of an investigation is to "determine whether the [SRO's] investigation has produced evidence meriting further proceedings"[59] – not to determine whether a violation has actually occurred.

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56 Exchange Act Section 15A(b)(8), 15 U.S.C. § 78*o*-3(b)(8); Section 15A(h)(1), 15 U.S.C. § 78*o*-3(h)(1). Cody claims that FINRA's investigation and disciplinary proceedings violated "United States Constitution Due Process protections." However, FINRA is a private actor, and accordingly is not bound by governmental constitutional and common law due process requirements. *See Desiderio v. NASD*, 2 F. Supp. 2d 516, 519 (S.D.N.Y. 1998), *aff'd*, 191 F.3d 198 (2d Cir. 1997); *Datek Sec. Corp. v. NASD*, 875 F. Supp. 230, 233 (S.D.N.Y. 1995) ("The NASD is a private corporation not subject to the strictures of the Constitution.").

57 *Cf. Kevin Hall*, Exchange Act Rel No. 61162 (Dec. 12, 2009), 97 SEC Docket 23679, 23714 (noting that respondents' "attempt to extend procedural protections for adjudications to the investigation [was] misguided"); *see also* NASD Rule 9211(c) (stating that a "disciplinary proceeding shall begin when the complaint is served and filed").

58 *Gold v. SEC*, 48 F.3d 987, 991 & 992 (7th Cir. 1995); *cf. Marshall v. Jerrico*, 446 U.S. 238, 248 (1980) (stating that the neutrality requirements "designed for officials performing judicial or quasi-judicial functions[] are not applicable to those acting in a prosecutorial or plaintiff-like capacity"); *Thomas E. Warren, III*, 51 S.E.C. 1015, 1020 (1994) (rejecting claim that SRO failed to conduct an "adequate investigation"), *aff'd*, 69 F.3d 549 (10th Cir. 1995) (table); *Frank J. Custable, Jr.*, 51 S.E.C. 855, 862 (1993) (finding that alleged bias of SRO investigator did not affect fairness of proceedings); *David D. Esco, Jr.*, 46 S.E.C. 1205, 1207 n.7 (1978) (same).

59 *David C. Ho*, Exchange Act Rel. No. 54481 (Sept. 22, 2006), 88 SEC Docket 3194, 3200, *aff'd*, 2007 WL 1224027 (7th Cir. 2007) (unpublished).

## B. Records and Testimony

Cody asserts that the Hearing Panel's refusal to grant his motion to obtain certain documents and testimony rendered the proceedings unfair. Before the hearing, Cody moved FINRA to compel production of a number of categories of Leerink documents pursuant to Rule 9252.[60] He requested and obtained Leerink phone records, copies of Leerink written supervisory procedures, compliance questionnaires, and customer files. The Department objected to several of his other Rule 9252 requests, however, including his requests for order tickets and Bloomberg communications. The hearing officer denied these additional requests, finding that Cody had failed to demonstrate that the documents sought would be relevant and material to the issues in the proceeding, that the requests were vague and overbroad and, in light of the minimal relevance of the documents, that the "the requests would impose a substantial and undue compliance burden on Leerink." Cody has not explained why he believes the hearing officer erred in denying these requests, nor has he established that any of the additional documentary evidence he sought would have aided in his defense of this proceeding.[61]

Cody also complains that FINRA failed to compel testimony from Skelly and Leerink management, and speculates that such persons might have offered testimony demonstrating the involvement or culpability of Skelly, his supervisors, or the Firm for his recommendations. However, Cody testified regarding the involvement of others at Leerink, including Skelly and other Leerink managers, in his trades. In any event, such testimony would not mitigate Cody's

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[60] As relevant here, a Rule 9252 request will be evaluated to determine whether the information or testimony is relevant, material, and non-cumulative; whether FINRA has jurisdiction over the sources of such documents or testimony; and "whether the request is unreasonable, excessive in scope, or unduly burdensome." Disciplinary proceedings by SROs such as FINRA do not provide for subpoenas. *Warren*, 51 S.E.C. at 1020 n.22.

[61] Cody asserts that the record should have included additional monthly statements, confirms, and order tickets, asserting that these types of documents are required in any disciplinary proceeding. However, he does not specify any information on these documents that would have excused or disproved the charged violations, particularly when the record includes: other documents that Cody admitted were consistent with the confirms, monthly statements for the periods and accounts at issue in this case, and testimony and documentary evidence regarding the confirms and the trading process. *See Kirlin Securities, Inc.*, Exchange Act Rel. No. 61135 (Dec. 10, 2009), 97 SEC Docket 23299, 23332 ("Because Applicants have failed to establish what information they were denied and how that denial prejudiced their case, we reject Applicants' argument that the proceedings against them were procedurally flawed."); *Gateway Stock & Bond*, 43 S.E.C. at 195 & n.9 (rejecting due process argument because "applicants have not shown that they were prejudiced by the manner in which evidence was presented . . . or that any material evidence was not produced."); *Epstein*, 95 SEC Docket at 13860 n.54 (noting that respondent "is not 'entitled to conduct a fishing expedition . . . in an effort to discover something that might assist him in his defense'. . . or 'in the hopes that some evidence will turn up to support an otherwise unsubstantiated theory'" (internal citations omitted)).

misconduct[62] because, as noted above, Cody had an independent obligation to comply with the provisions at issue here and cannot shift this responsibility to others.[63]

In addition, Cody argues that FINRA improperly denied him the opportunity to present expert witness testimony. He contends that his expert would have addressed, among other things: errors on Leerink statements and other exhibits and calculations; Leerink's responsibility for Cody's recommendations; and the propriety of his trading strategy. He also claims that the expert would have testified regarding the differences between ABSs and collateralized mortgage obligations (CMOs) and whether Cody's trading was excessive.

In determining whether securities law violations have occurred, "neither we nor NASD is hindered by the lack of, or is bound by, expert testimony."[64] The Hearing Panel and the NAC act as expert bodies whose 'businessman's judgment' may be brought to bear in reaching . . . decision[s]"[65] based on their "collective business experience."[66] In reviewing disciplinary action taken by an SRO, we are not bound to admit or consider expert testimony.[67]

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62 *See Kirlin Sec.*, 97 SEC Docket at 23331 (finding no irregularity in FINRA exclusion of testimony that was "unlikely to have added to the description of the market activity . . . already provided by Applicants"); *Ronald Pellegrino*, Exchange Act Rel. No. 59125 (Dec. 19, 2008), 94 SEC Docket 12628, 12652 & nn.56-57 (finding that the fairness of NASD disciplinary action was not compromised by exclusion of testimony by NASD employee that was not "relevant and material" when respondent testified about conversations with the NASD employee); *A.S. Goldman & Co*, 55 S.E.C. 147, 168-69 (2001) (rejecting due process challenge based on exclusion of testimony that was "not probative" of the violations charged); *U.S. Sec. Clearing Corp.*, 52 S.E.C. 92, 100-01 (1994) (rejecting challenge based on exclusion of NASD employee testimony when "testimony [was] irrelevant" because "these violations are amply supported by the record" and applicant "was permitted to testify about these conversations").

63 *See Audifferen*, 93 SEC Docket at 8141 (noting that applicant "cannot shift the blame for his violations to his firm"); *Barry C. Wilson*, 52 S.E.C. 1070, 1073 n.12 (1996) (noting that "failings on the part of certain firm personnel do not excuse misconduct by others").

64 *Kirlin Sec.*, 97 SEC Docket at 23321 n.74.

65 *Meyer Blinder*, 50 S.E.C. 1215, 1222 n.32 (1992).

66 *Reynolds*, 50 S.E.C. at 809.

67 *Kirlin Sec.*, 97 SEC Docket at 23321 n.74; *see also Gregory M. Dearlove*, Exchange Act Rel. No 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1897-98, *petition denied*, 573 F.3d 801 (D.C. Cir. 2009) (stating that "the SEC need not have received expert testimony to establish the standard of care [for accountants] or to determine whether Dearlove's conduct was unreasonable"); *Christiana Sec. Co.*, 45 S.E.C. 648, 659-60 n.38 (1974) (declining to resolve issue through use of financial expert opinions when "the questions presented were . . . essentially legal" and "cannot be resolved by reference to the opinions of financial experts, however

Cody first sought to introduce expert testimony by designating an expert on the witness list he filed on October 3, 2008, several weeks before the hearing. He asserted that the expert testimony would "help clarify . . . fixed income (1) products; (2) trading desk procedures; (3) investment methodologies[;] (4) ratings; and (5) the specific investments in the client's accounts." The Department objected, arguing that the May 9, 2008 deadline for motions for leave to offer expert testimony established in the scheduling order had long passed, and that the Department would not have sufficient time before the hearing to prepare to cross-examine or rebut such testimony. During a pre-hearing conference, the hearing officer noted the Hearing Panel's "very extensive experience in the securities industry" and familiarity with the proposed topics of expert testimony, and that Cody had not submitted an expert report to "explain[] in detail what the expert's proposed testimony would be in advance of the hearing." The full Hearing Panel considered the expert testimony as then proposed by Cody, and in a pre-hearing order dated October 20, 2008, unanimously concluded that such expert testimony "would not be necessary or helpful to the Panel in resolving the issues in this proceeding."[68] Cody renewed his request for expert testimony at the beginning of the hearing. The Hearing Officer again denied the request, but suggested that the panel might reconsider the motion if it saw "something [during the hearing] that the expert's expertise would be really helpful to us and our need to understand the case." Cody did not renew the request after the cross-examination of the FINRA examiner. During the NAC appeal, Cody sought an extension of the deadline to file a motion for leave to offer expert testimony to the NAC. Under NASD Rule 9346(b) such a motion requires a showing of "good cause." NAC denied Cody's motion, which again did not include a report detailing the expert's testimony.

Cody cites *Shad v. Dean Witter Reynolds, Inc.*, for the proposition that expert testimony is required to evaluate any charge of excess trading.[69] That case, however, is inapposite. *Shad* dealt with the inability of a lay jury to evaluate investment risk, suitability, trading patterns, and otherwise "meaningless numbers from which they cannot judge the appropriateness of the

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conscientious and however eminent."); *IMS/CPAs & Assocs.*, 55 S.E.C. 436, 460 & n.45 (2001) (finding that the accuracy of responses on a Form ADV "goes directly to the issue of whether a violation occurred" and deeming such issue "a legal question within the purview of the law judge and the Commission to determine").

[68] NASD Rule 9263(c) – now recodified as FINRA Rule 9263(a) – permits the exclusion of "irrelevant, immaterial, unduly repetitious or unduly prejudicial" evidence.

[69] 799 F.2d 525 (9th Cir. 1986).

transactions."[70] Both FINRA and the Commission, however, have the expertise to evaluate such evidence without expert testimony.[71]

Cody suggests that expert testimony would have addressed errors on the Leerink statements exhibits and other exhibits. However, Cody was given wide latitude during cross-examination of the FINRA examiner to address these purported errors and to argue for the exclusion of Division exhibits and calculations. He also submitted his own exhibits illustrating his trading. Based on our review of Cody's claims and the evidence, we find that Cody has not substantiated a need for expert testimony.[72]

### C. Notice of the Suitability Charges Regarding the Credit Suisse Securities

Cody also claims that he was not afforded sufficient notice to offer a defense to the charge that his recommendation of the Credit Suisse Securities violated the suitability rule. In advancing this notice argument, Cody focuses on the fact that the Credit Suisse Securities have been characterized variously as CMOs and as ABSs during the FINRA proceedings. The Complaint that initiated the FINRA proceedings described the Credit Suisse Securities as "Credit Suisse First Boston Indymac 7.105% 2028 Collateralized Mortgage Obligation securities (CSFB CMO)." The testimony and briefs in the FINRA proceedings and the Hearing Panel decision generally refer to the Credit Suisse Securities as CMOs.[73] On appeal, the NAC concluded that the Credit Suisse Securities were more appropriately characterized as ABSs rather than CMOs because they were collateralized by installment loan agreements.

Cody claims that, given the NAC's characterization of the Credit Suisse Securities as ABSs, he was denied notice and an opportunity to offer a defense based on the "different

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70 *Id.* at 530. Cody also cites *Costello v. Oppenheimer & Co.* for the proposition that experts are "customar[ily] . . . call[ed]" in churning cases considered by the courts "to testify on the question of whether excessive trading has taken place." 711 F.2d 1361, 1369 (7th Cir. 1983). The court in *Costello*, like *Shad*, dealt with a churning decision made by a jury. The court ultimately found that the jury was entitled to find churning without considering expert testimony.

71 Cody argues that the NAC decision regarding expert testimony supports his contention that he should have been allowed to introduce expert testimony. However, the NAC found that such testimony would have been helpful on only one issue – whether the Credit Suisse Securities were speculative despite the investment grade rating when purchased. Cody was not prejudiced because, given the lack of evidence on this issue, the NAC declined to find that the Credit Suisse Securities were speculative.

72 *See also* discussion of our review of FINRA exhibits in text preceding note 43 *supra*.

73 Certain documents in the record (including Cody's pre-hearing memorandum, the Leerink statements, and Cody's testimony) describe the Credit Suisse Securities as ABSs.

investment benefits, different risk factors and different previous investment experience by the clients and Cody" applicable to ABSs rather than CMOs.[74] We do not find merit in this argument. Notice is sufficient in a disciplinary proceeding "[a]s long as the party . . . is reasonably apprised of the issues in controversy"[75] and "is afforded a full opportunity" to address the charged violations.[76] Here, Cody had notice of the basis for the charged suitability violations and which Credit Suisse Securities were at issue. The Complaint alleged that Cody recommended the Credit Suisse Securities "without having reasonable grounds for believing that the securities were suitable," and cited his failure to "conduct any due diligence" on the security. Cody admitted at the hearing that he did not understand the Credit Suisse Securities when he made the recommendations, and this admission was sufficient to establish the suitability violations regardless of whether the securities were ABSs or CMOs. Moreover, Cody has never claimed any confusion about which Credit Suisse Securities were at issue.[77] We find that Cody

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[74] The definition of "asset-backed securities" in Section 3(a)(77) of the Exchange Act includes collateralized mortgage obligations. 15 U.S.C. § 78c(a)(77)(A)(i) (defining ABS as "a fixed-income or other security collateralized by any self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including – (i) a collateralized mortgage obligation . . . ").

[75] *Steven E. Muth*, 58 S.E.C. 770, 792-93 n.40 (2005) (finding that allegation provided sufficient notice where it alleged applicant "engaged in various sales practice violations," but "did not specify unauthorized trades"); *see also Rita J. McConville*, 58 S.E.C. at 627 (noting that NYSE "need not disclose to the respondent the evidence upon which [it] intends to rely" if it provides enough detail for the respondent to prepare a defense).

[76] *See Piontek*, 57 S.E.C. at 90-91 (finding that respondent who "understood the issue[s]" and "'was afforded full opportunity' to litigate" had sufficient notice of the charges (quotations and citations omitted)); *KPMG Peat Marwick*, 55 S.E.C. 1, 4 (2001) ("As long as a party to an administrative proceeding is reasonably apprised of the issues in controversy and is not misled, notice is sufficient."), *petition denied*, 289 F.3d 109 (D.C. Cir. 2002); *cf. Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 262 (D.C. Cir. 1979) (noting that, in administrative proceedings, "[i]t is sufficient if the respondent 'understood the issue' and 'was afforded full opportunity' to justify its conduct during the course of the litigation").

In general, "administrative pleadings are very liberally construed," and courts accord agencies considerable latitude to interpret charging documents. *National Realty & Construction Co. v. ASHRC*, 489 F.2d 1257, 1264 (D.C. Cir. 1973). Thus, the "question on review is not the adequacy of the pleadings . . . but is the fairness of the entire procedure." *Aloha Airlines*, 598 F.2d at 262 (quoting 2 K. Davis, Administrative Law Treatise, § 8.04 (1958)).

[77] Bloomberg printouts and monthly Leerink statements in the record identify the full title and CUSIP number of the Credit Suisse Securities, and Cody submitted exhibits illustrating his trades in these securities.

had a full opportunity to address the charge that his recommendations of the Credit Suisse Securities were unsuitable.

## D. Other Procedural Claims

Cody's other procedural objections are similarly without merit. Asserting "inconsistent and abusive behavior by FINRA," he argues that FINRA did not bring a disciplinary proceeding against other persons who recommended similar transactions. To the extent that Cody claims to be a victim of selective prosecution, he must establish that he was a member of a protected class under the Equal Protection Clause, that "prosecutors acted with bad intent, [and] that similarly situated individuals outside the protected category were not prosecuted."[78] Cody has not made these required showings. To the extent that he argues that FINRA was motivated by bias or an improper desire to punish him, we do not find evidence of bias or that Cody was treated unfairly during the FINRA proceedings. In addition, our *de novo* review of the evidence cures whatever bias, if any, that may have existed.[79]

Cody asserts that the Department's appeal to the NAC did not specify the basis for its appeal. We find that the Department's notice adequately described its appeal of "sanctions, including specifically the Panel's declining to order restitution." Moreover, the NAC subsequently notified the parties that its decision could cover "all substantive, procedural, and sanctions-related issues." The Department also made its contentions clear in its briefs to the NAC.

Finally, Cody argues that the Hearing Panel and the NAC decisions were unduly delayed, and that the decisions were not served by the deadlines set by the applicable rule. Rule 9268 establishes a sixty-day limit for the preparation of a hearing panel decision.[80] However, this time frame applies to the hearing officer's distribution of the draft opinion to other hearing panel members, not the issuance of the hearing panel decision.[81] Cody has not shown that this limit

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78 *Fog Cutter Capital Group Inc. v. SEC*, 474 F.3d 822, 826 (D.C. Cir. 2007).

79 *Robert Bruce Orkin*, 51 S.E.C. 336, 344 (1993) (finding that the Commission's "*de novo* review . . . cures whatever bias or disregard of precedent or evidence, if any, that may have existed below"), *aff'd*, 31 F.3d 1056 (11th Cir. 1994).

80 Cody argues that "the rules require [the Hearing Panel decision] to be served in 90 days," but does not cite a specific rule as the basis for this claim.

81 *Howard*, 55 S.E.C. at 1104. Rule 9348 sets forth the framework for service of the NAC decision to the parties.

was contravened, or that either alleged delay resulted from any lack of diligence on FINRA's part or caused him prejudice.[82]

V.

On appeal, Cody challenges the one-year suspension and a $20,000 fine imposed by the NAC for the suitability violations.[83] Exchange Act Section 19(e) directs us to sustain FINRA's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[84] For the violations of the suitability rule, FINRA referenced its Sanction Guidelines recommending a fine between $2,500 and $75,000, suspension for a period of ten business days to one year and, in egregious cases, a longer suspension of up to two years or a bar.[85]

Cody engaged in repeated violations of the suitability rule that warrant serious sanctions. He recommended that Mr. Bates and the DeSimones invest considerable amounts of their retirement savings in a security that he did not understand. His recommendations of non-investment grade securities for Mr. Bates did not conform to Mr. Bates' clearly stated conservative investment goals and low risk tolerance. Cody also used his control over Mr. Bates' and Ms. DeSimone's accounts to pursue short-term, excessive trading that was inconsistent with their investment objectives and needs.

Numerous aggravating factors support the sanctions. As FINRA found, Cody's violations amounted to a "pattern of misconduct over an extended period of time," were "significant," especially in light of the size and nature of the accounts, and generated commissions for Cody.

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[82] Nor has Cody established that he suffered any prejudice because the Hearing Officer indicated his belief that Cody's conduct justified a six-month suspension in a footnote rather than a dissent.

[83] Cody does not challenge the fines for the Form U4 and spreadsheet violations. FINRA consulted the Sanction Guidelines, which recommend a fine from $2,500 to $25,000 for a failure to file a Form U4 amendment, and a fine from $5,000 to $100,000 for falsification of records. The fines imposed by FINRA ($2,500 for the Form U4 violation and $5,000 for the spreadsheet violations) are at the low end of these guidelines, and we find them neither excessive nor oppressive and in the public interest.

[84] 15 U.S.C. § 78s(e)(2).

[85] FINRA Sanction Guidelines at 99 (2007 ed.). "Although the Commission is not bound by the Guidelines, we use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2)." *CMG Institutional Trading, LLC*, Exchange Act Rel. No. 53925 (Jan. 30, 2009), 95 SEC Docket 13802, 13814 n.38; *Paz Sec., Inc.*, Exchange Act Rel. No. 57656 (April 11, 2008), 93 SEC Docket 5122, 5125, *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009).

Moreover, the Customers were elderly, retired or near retirement, not sophisticated "when it came to bond trading and active trading," and did not understand how the market values of their accounts were determined. The Customers entrusted Cody with considerable discretion over their retirement savings and, based on Cody's assurances, believed that he was acting in their interest.

We are particularly troubled by Cody's responses to Customer questions, which often suggested efforts to deflect their legitimate concerns and lull them into inaction. These efforts to lull the customers into inactivity or mislead the customers aggravate the seriousness of Cody's suitability violations.[86] For instance, when Mr. Bates asked about a sharp decline in the value of the Credit Suisse Securities in the summer of 2003, Cody told him not to worry. He suggested that the decline did not affect "[Mr. Bates'] particular bond" even though other evidence confirms that the market for the Credit Suisse Securities was then sharply declining. When Ms. DeSimone inquired about the Credit Suisse Securities in November 2003, Cody told her "Don't worry about it. Everything is safe." When Ms. DeSimone asked Cody about frequent trading in her account in late 2003 or early 2004, Cody responded, "Don't worry about it. It is going to work out." In addition, when the Customers expressed concern over their losses in the Credit Suisse Securities in 2004, Cody suggested that they would be reimbursed. Cody also discouraged the Customers from reviewing Leerink statements that included information omitted from or obscured by Cody's spreadsheets. Cody's misleading responses to Customers questions, together with his attempts to shift blame for his recommendations to others, demonstrate a fundamental misunderstanding of his responsibilities as a securities professional.

Cody argues that his settlements with the Customers mitigate the seriousness of his violations, and that he should be credited for settling against the recommendation of his attorney and before the Customers had "registered a formal complaint." The Sanction Guidelines, however, provide that a representative's acknowledgment and attempts to remedy misconduct are mitigating if made "voluntarily and reasonably" and "prior to detection and intervention."[87] These guidelines are not satisfied. Cody entered into the settlements, which were drafted and recommended by a Firm compliance officer, after the Customers complained and the Firm investigated.

Cody challenges the NAC's decision to increase the suspension from three months to a year, asserting that it was based on the NAC's characterization of the Credit Suisse Securities as ABSs. As discussed above, we find no merit to this claim. Moreover, we have repeatedly held

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[86] Sanction Guidelines at 6; *see also Pinchas*, 54 S.E.C. at 348 n.40 (stating that "[i]f a respondent commits more serious misconduct during the excessive trading, such as attempting to lull the investor, or being untruthful about the transactions, the respondent may face a longer suspension or a bar"); *Bucchieri*, 52 S.E.C. at 806 (noting SRO guidelines calling for "a suspension or bar in cases involving serious misconduct such as excessive trading in more than one account or attempts to lull investors").

[87] Sanction Guidelines at 6.

that the NAC reviews hearing panel decisions *de novo* and has broad discretion to review hearing panel decisions and sanctions.[88] The procedural rules expressly authorize the NAC to increase sanctions.[89]

Cody also complains that FINRA declined to discipline other registered representatives when it settled charges that another member firm failed to implement an adequate supervisory system and procedures relating to its representatives' recommendations of CMOs to retail customers. It is well established, however, that the appropriateness of a sanction "depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with the action taken in other proceedings."[90] This is especially true with regard to

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88 *See Michael B. Jawitz*, 55 S.E.C. 188, 200 & n.24 (2001) (stating that the NAC conducts a *de novo* review and has broad discretion to review any finding in the Hearing Panel decision) (citing *Timothy L. Burkes*, 51 S.E.C. 356, 359 (1993), *aff'd*, 29 F.3d 630 (9th Cir. 1994) (table)); *cf. Morton Bruce Erenstein*, Exchange Act Rel. No. 56768 (Nov. 8, 2007), 91 SEC Docket 3114, 3126 (acknowledging NAC's power to conduct a *de novo* review and make independent findings), *petition denied*, No. 07-15736 (11th Cir. 2008) (unpublished); *see also Chris Dinh Hartley*, 57 S.E.C. 767, 776 (2004) (finding NASD's sanctions not excessive or oppressive where the NAC increased a suspension imposed by hearing panel from thirty days to ninety days for selling away violation); *James B. Chase*, 56 S.E.C. 149, 162 (2003) (finding NASD's sanctions not excessive or oppressive where NAC increased hearing panel's suspension from six months to one year for violations involving unsuitable recommendations).

89 NASD Rule 9348; *Joseph Abbondante*, 58 S.E.C. 1082, 1111 (2006), *aff'd*, 209 F. App'x 6 (2d Cir. 2006). We also reject Cody's various arguments for remand to the NAC or a hearing panel. We conduct a *de novo* review of the NAC decision, and the findings herein are based on the record evidence. *See John M.E. Saad*, Exchange Act Rel. No. 62178 (May 26, 2010), 98 SEC Docket 28591, 28599 n.12 ("we review only the NAC's decision on appeal"), *appeal filed*, No. 10-1195 (D.C. Cir. July 23, 2010); *Philippe N. Keyes*, Exchange Act Rel. No. 54723 (Nov. 8, 2006), 89 SEC Docket 792, 800 n.17 ("[I]t is the decision of the NAC, not the decision of the Hearing Panel, that is the final action of NASD which is subject to Commission review.").

90 *Paz Sec.*, 93 SEC Docket at 5134 (citing *Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973) ("The employment of a sanction within the authority of an administrative agency is thus not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases.")), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009); *see also Geiger v. SEC*, 363 F.3d 481, 488 (D.C. Cir. 2004) ("The Commission is not obligated to make its sanctions uniform, so we will not compare this sanction to those imposed in previous cases."); *Hiller v. SEC*, 429 F.2d 856, 858 (2d Cir. 1970) ("[W]e cannot disturb the sanctions ordered in one case because they were different from those imposed in an entirely different proceeding.").

settled cases, like the one cited by Cody, "where pragmatic factors may result in lesser sanctions."[91]

Cody further argues that these proceedings create an unnecessary or inappropriate burden on competition by discouraging voluntary settlements and employment in the securities industry. As we have previously held, these factors are "not the type of competitive concern that Exchange Act Section 19 meant to be considered."[92] The "unnecessary or inappropriate burden on competition" requirement was added to Section 19 to "break down the unnecessary regulatory restrictions which . . . restrain competition among markets and market makers . . . ."[93] In disciplining those who make unsuitable recommendations, FINRA is fulfilling its Exchange Act mandate "to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest"[94] by encouraging competition based on appropriate sales practices.

Cody's conduct raises serious questions about his commitment to future compliance with the suitability requirements. Given the seriousness of each of Cody's suitability violations, we find that the relatively lenient one-year suspension and $20,000 fine for these violations will protect the public interest by encouraging Cody and others to take the steps necessary to appropriately investigate the investments they recommend, and to tailor recommendations to the objectives and risk tolerances of their customers. Accordingly, we find that these sanctions do

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91 *Anthony A. Adonnino*, 56 S.E.C. 1273, 1295 (2003), *aff'd*, 111 F. App'x 46 (2d Cir. 2004); *see also Gary Kornman*, Exchange Act Rel. No. 59403 (Feb. 19, 2009), 95 SEC Docket 14246, 14260-61 (affirming bar and rejecting applicant's comparison to an allegedly similar, settled matter that involved a lesser sanction), *aff'd*, 592 F.3d 173 (D.C. Cir. 2010).

92 *Howard Brett Berger*, Exchange Act Rel. No. 58950 (Nov. 14, 2008), 94 SEC Docket 11615, 11634, *petition denied*, 2009 WL 3160620 (2d Cir. 2009).

93 S. Rep. No. 94-75 at 12-13 (1975); *see* Securities Reform Act of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.).

94 15 U.S.C. § 78*o*-3(b)(6); *see also Berger*, 94 SEC Docket at 11634 n.73. Cody also requests "reimbursement for attorney fees and costs." We see no reason for awarding costs to Cody since, as discussed herein, FINRA was amply justified in bringing this proceeding. In any event, he has cited to no basis for the awarding of costs to an applicant, and we are unaware of any such provision. *See N. Woodward Fin. Corp.*, Exchange Act Rel. No. 60505 (Aug. 14, 2009), 96 SEC Docket 19837, 19847 n.29.

not impose an unnecessary or inappropriate burden on competition and are neither excessive nor oppressive.

An appropriate order will issue.[95]

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

Elizabeth M. Murphy
Secretary

Cathy H. Ahn

By: Cathy Ahn
Deputy Secretary

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95 We have considered all of the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 64565 / May 27, 2011

Admin. Proc. File No. 3-13932

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In the Matter of the Application of

RICHARD G. CODY
c/o Stephen Z. Frank, Esq.
P.O. Box 129
North Conway, NH 03860

For Review of Disciplinary Action Taken by

FINRA

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ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

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

ORDERED that the disciplinary action taken, and the costs imposed, by FINRA against Richard G. Cody, be, and they hereby are, sustained.

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
Rel. No. 64557 / May 27, 2011

Admin. Proc. File Nos. 3-14307 and 3-14308

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| In the Matter of the Application of<br><br>WORLD TRADE FINANCIAL CORP.,<br>JASON TROY ADAMS, FRANK EDWARD<br>BRICKELL, and RODNEY PRESTON MICHEL<br><br>For Review of Disciplinary Action Taken by FINRA | ORDER<br>DENYING<br>CONSOLIDATION |
| In the Matter of the Application of<br><br>MIDAS SECURITIES, LLC, and<br>JAY S. LEE<br><br>For Review of Disciplinary Action Taken by FINRA | |

On March 3, 2011, the Financial Industry Regulatory Authority ("FINRA") issued a decision in a disciplinary action that involved Applicants in the above-captioned matters.[1] FINRA's decision found that FINRA member firms World Trade Financial Corp. ("World Trade") and Midas Securities, LLC ("Midas Securities"), and Frank Edward Brickell, an associated person of World Trade, sold unregistered shares of iStorage Networks, Inc. ("iStorage"), stock in violation of Section 5 of the Securities Act of 1933 and NASD Rule 2110.

In connection with these violations, FINRA found that World Trade and its principals Rodney Preston Michel and Jason Troy Adams violated NASD Rules 3010 and 2110 by failing to maintain adequate written supervisory procedures and failing to supervise the registered representatives who were participating in the unregistered securities sales. FINRA also found that Midas Securities and its principal Jay S. Lee committed similar supervisory violations. It

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1 *Dep't of Enforcement v. Midas Sec., LLC, World Trade Fin. Corp., Jason Troy Adams, Frank Edward Brickell, Jay S. Lee, and Rodney Preston Michel*, Complaint No. 2005000075703 (FINRA NAC decision Mar. 3, 2011), 2011 WL 786035.

fined World Trade $45,000, Midas Securities $80,000, Brickell $15,000, Michel $30,000, Adams $20,000, and Lee $50,000 and suspended Brickell, Adams, and Lee for their misconduct.

On March 24, 2011, World Trade, Brickell, Michel, and Adams (the "World Trade Applicants") and Midas Securities and Lee (the "Midas Securities Applicants") filed separate petitions for review of FINRA's decision, and the Commission's Office of the Secretary designated the two proceedings as separate appeals. On April 15, 2011, FINRA filed a motion to consolidate the two proceedings, arguing that, with limited exception, the separate petitions for review "contain nearly identical challenges to FINRA's findings of fact, conclusions of law, and sanctions imposed in the March 3 Decision."

On April 28, 2011, the World Trade Applicants and the Midas Securities Applicants filed oppositions to FINRA's motion, claiming, among other things, that the two firms "are wholly unrelated," "were not working together, [and] were not involved in the same transactions," and that the only commonality between them is that they both have been charged by FINRA with the unregistered sale of the same security. Applicants assert that "each firm has a different set of circumstances" with respect to the sanctions imposed and that they "will be prejudiced" if the matters are consolidated.

Commission Rule of Practice 201(a) provides that we may order consolidation of proceedings "involving a common question of law or fact."[2] Our initial examination of FINRA's decision suggests that, although FINRA alleges similar violations with respect to the sale of iStorage shares, each of the individual allegations is based on distinct facts that are specific to each firm.[3] There is no claim of any relationship between the firms or that the firms acted in concert in connection with the alleged sales. Moreover, the facts and issues relating to the supervisory allegations differ with each firm and associated person involved. Under the circumstances, we do not believe our review of FINRA's disciplinary action will benefit from consolidation of the proceedings.

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2 17 C.F.R. § 201.201(a).

3 *See Frank J. Custable, Jr.*, Order Denying Consolidation, Admin. Proc. File Nos. 3-7742 and 3-7899 (Jan. 7, 1993) (denying consolidation of proceedings, despite involving the same individual and "similar violations," because, among other reasons, of the "distinct facts" underlying the allegations).

Accordingly, it is ORDERED that the request of FINRA for consolidation of the above-titled proceedings be, and it hereby is, denied.

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. 64558 / May 27, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3211 / May 27, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14403**

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| **In the Matter of**<br><br>**WUNDERLICH SECURITIES, INC.,**<br>**TRACY L. WISWALL, and**<br>**GARY K. WUNDERLICH, JR.,**<br><br>**Respondents.** | **ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS** |

## I.

The Securities and Exchange Commission (the "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 15(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (the "Advisers Act") against Wunderlich Securities, Inc. ("WSI"), and pursuant to Section 15(b) of the Exchange Act and Sections 203(f) and 203 (k) of the Advisers Act against Tracy L. Wiswall ("Wiswall") and Gary K. Wunderlich, Jr. ("Wunderlich") (WSI, Wiswall, and Wunderlich being sometimes hereinafter referred to individually as a "Respondent" and collectively as the "Respondents").

## II.

In anticipation of the institution of these proceedings, each Respondent has submitted an Offer 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 Respondents and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting

Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders (the "Order"), as set forth below.

### III.

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

#### A. Summary

1. WSI, an investment adviser and broker-dealer registered with the Commission, willfully[1] violated several antifraud and compliance provisions of the Advisers Act and the rules thereunder. Wiswall and Wunderlich willfully aided and abetted and caused certain of WSI's violations. During the relevant periods, Wiswall served as WSI's chief compliance officer ("CCO") and Wunderlich served as WSI's chief executive officer ("CEO").

2. From at least 2007 through 2009, WSI: overcharged advisory clients for commissions and other transactional fees in violation of Section 206(2) of the Advisers Act; failed to satisfy the disclosure and consent requirements of Section 206(3) of the Advisers Act when WSI engaged in principal trades with advisory clients; failed to adopt, implement and review written policies and procedures as required by Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; and failed to establish, maintain, and enforce a written code of ethics as required by Section 204A of the Advisers Act and Rule 204A-1 thereunder. Wiswall was a cause of WSI's violations relating to the firm's principal trades with advisory clients. In addition, both Wiswall and Wunderlich willfully aided and abetted and caused WSI's violations relating to its written policies and procedures and written code of ethics.

#### B. Respondents

3. WSI is a Tennessee corporation based in Memphis, Tennessee with several branch offices throughout the United States. WSI founded its brokerage operations in or about 1996 and later maintained state investment adviser registrations. Effective February 2007, WSI registered with the Commission as an investment adviser. In its Form ADV filed as of April 2011, WSI reported approximately $469 million in advisory client assets under management held in 1,136 discretionary accounts and 1,140 non-discretionary accounts.

4. Wiswall, age 37, served as the CCO of WSI's brokerage and advisory businesses from 2004 until at least 2009. During the relevant periods, Wiswall maintained securities licenses as a registered representative associated with WSI.

5. Wunderlich, age 40, is the principal founder, CEO, a director, and an indirect part-owner of WSI. He has held general and/or principal securities licenses since at least

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[1] 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)).

1992. During the relevant periods, Wunderlich served as Wiswall's sole and direct supervisor. In addition, during the relevant periods, Wunderlich maintained securities licenses as an investment adviser representative and a registered representative associated with WSI.

## C. Facts

### *Overview of WSI Operations and Roles of Wunderlich and Wiswall*

6. WSI established its operations in or about 1996 through the acquisition of an existing registered broker-dealer. WSI's core business historically has been its brokerage operations. However, after its formation, WSI also provided investment advisory services to advisory clients.

7. Wunderlich is WSI's principal founder and has served as the CEO or other senior executive officer of WSI since its inception. As CEO, Wunderlich has had overall responsibility for ensuring that WSI complies with its regulatory requirements, including applicable requirements under the Advisers Act and its rules.

8. In 2004, Wunderlich hired Wiswall to serve as CCO of WSI's brokerage and advisory businesses. When hired, Wiswall was a senior compliance examiner with the National Association of Securities Dealers, Inc. ("NASD"), with several years experience in broker-dealer compliance. Prior to joining the NASD, Wiswall briefly was employed as a registered representative associated with a registered broker-dealer. Wiswall had little or no practical experience with the regulatory requirements applicable to investment advisers when he joined WSI, including those regulatory requirements specifically applicable to Commission-registered advisers. Wunderlich knew that Wiswall had little or no such practical experience when Wunderlich hired Wiswall.

9. At the time that Wiswall joined WSI, the firm maintained only state investment adviser registrations and typically had less than $10 million in advisory client assets under management. Under Wunderlich's direction, Wiswall was responsible for overseeing the preparation and filing of the Form ADVs used to maintain WSI's state investment adviser registrations.

10. In October 2006, WSI filed a Form ADV to register with the Commission as an investment adviser. Wiswall oversaw the preparation and filing of the Form ADV, which Wunderlich signed. WSI's registration with the Commission as an investment adviser became effective on February 5, 2007 (the "SEC Registration").

11. Shortly after the SEC Registration, WSI substantially expanded its advisory operations. First, in March 2007, WSI added more than $70 million of new client assets under management through WSI's purchase of all of the advisory and brokerage accounts of a Commission-registered investment adviser and broker-dealer based in Ohio with offices in other states (the "Ohio Registered Entity"). WSI formed a separate division for this new business (the "Ohio Division"), and most of the persons formerly associated with the Ohio Registered Entity became new associated persons of WSI. As a result, within weeks of the SEC Registration, WSI

became responsible for overseeing the activities of numerous new associated persons in Ohio and around the United States as well as hundreds of new client accounts.

12. In addition, within months of the SEC Registration, WSI began to convert hundreds of its existing fee-based brokerage accounts to investment advisory accounts, in response to regulatory changes affecting certain broker-dealers that provided investment advice. The conversions of the brokerage accounts likely resulted in at least $100 million of additional client assets under management for WSI and a substantial increase in new advisory client accounts.

13. Wunderlich assigned to Wiswall, as CCO, the responsibility for establishing and administering WSI's advisory compliance programs under Wunderlich's direction. As WSI's advisory operations rapidly expanded, Wiswall's compliance responsibilities grew substantially. When WSI initially formed the Ohio Division, Wiswall was assisted in his duties by the individual who formerly served as CCO of the Ohio Registered Entity. A few weeks after the acquisition, however, WSI terminated that individual's employment. As a result, after the acquisition of the Ohio Division and the firm's conversion of its existing fee-based brokerage accounts to advisory accounts, Wiswall became responsible for monitoring the compliance functions of more than $170 million of client assets under management in hundreds of new advisory client accounts.

14. Wiswall served as CCO from 2004 throughout the relevant periods at issue. However, for limited periods in 2008 and 2009, another WSI employee served as CCO of the Ohio Division while Wiswall continued to serve as CCO for the remainder of the firm.

***WSI Charged Excessive Fees to Numerous Advisory Clients in Thousands of Separate Transactions***

15. From at least January 2007 through October 2009, WSI overcharged commissions and other transactional fees to advisory clients totaling approximately $120,835 in approximately 6,338 separate transactions. The overcharges appear to have occurred primarily due to back-office errors, when WSI representatives throughout the firm incorrectly entered fees when placing trade orders and the firm's internal systems for fee reviews did not uncover the errors. The overcharged amounts varied and generally ranged from $5 to $29. Prior to the entry of this Order, WSI voluntarily refunded $120,835 in overcharges to the affected clients.

16. The fee overcharges occurred in two contexts. First, many of the clients who were overcharged were enrolled in certain "wrap fee" investment advisory programs offered through WSI (the "Wrap Fee Programs"). Clients in these Wrap Fee Programs had contracted with WSI to pay one bundled or "wrap" fee for advisory, execution, clearing, and custodial services, except as specifically provided in their written advisory client agreements. However, in at least 5,764 separate transactions, WSI charged commissions and other transactional fees to certain of these wrap fee accounts that were contrary to the fees disclosed in the clients' written advisory agreements.

17. Second, WSI overcharged numerous clients who participated in an investment advisory program offered by the Ohio Division called the CSA Advisor Program (the "CAP Program"). Advisory client agreements for the CAP Program typically disclosed that clients would pay "one all-inclusive fee and a minimal $29.00 per trade commission." Some agreements

added a $5 per trade confirmation fee. In addition, many individual client agreements contained different fee arrangements that were negotiated with the client, so that some clients might pay reduced or no trade-related fees. In at least 574 separate transactions, WSI erroneously collected commissions and other transactional fees that were not consistent with the fees disclosed in the clients' individual CAP Program agreements.

***WSI Failed to Satisfy Disclosure and Client Consent Requirements When WSI Engaged in Principal Trades with Clients, and Wiswall Was a Cause of the Violations***

18. From at least February 2007 through September 2009, WSI knowingly effected thousands of securities transactions for advisory clients while WSI acted as a principal for its own account. Pursuant to Section 206(3) of the Advisers Act, WSI was required to disclose to such clients in writing before the completion of each transaction that WSI was acting as a principal. WSI also was required to obtain the clients' consent to each transaction. However, with respect to at least 3,000 of these principal trades (the "Relevant Principal Trades"), WSI failed to satisfy the disclosure and consent requirements mandated by Section 206(3) of the Advisers Act.

19. WSI profited from the Relevant Principal Trades because WSI received commissions in connection with the trades as well as mark-ups or mark-downs represented by the spread between the cost of the traded securities to WSI and the cost of the traded securities to the advisory clients. From February 2007 through September 2009, WSI obtained $398,570.51 in such compensation from the Relevant Principal Trades, consisting of $134,793.51 in commissions and $263,777 in mark-ups or mark-downs. WSI voluntarily refunded or credited $29,234.36 of such commissions to affected advisory clients prior to the entry of this Order. WSI has not yet refunded or credited to affected clients the remaining difference of $369,336.15 (the "Remaining Principal Trade Compensation").

20. Wiswall, at Wunderlich's direction, was responsible for monitoring WSI's overall compliance with the Advisers Act, including WSI's disclosure and consent requirements when the firm engaged in principal trades with advisory clients. In 2007, a representative of an outside consulting firm (the "Consultant") specifically brought the disclosure and consent requirements of Section 206(3) of the Advisers Act to Wiswall's attention. At Wiswall's request and with Wunderlich's consent, WSI had retained the Consultant in July 2007 to conduct a review of WSI's advisory business in light of Wiswall's inexperience with Commission-registered investment advisers. The Consultant interviewed Wiswall in an on-site visit, obtained from Wiswall various documents relating to the advisory business, and engaged in follow-up communications with Wiswall concerning the Consultant's review and recommendations.

21. In August 2007, the Consultant sent Wiswall an e-mail containing the subject line "Principal Transaction Rules." The Consultant stated in the e-mail that "[h]ere is the specific rule regarding principal transactions from the RIA side," and then quoted for Wiswall the precise language of Section 206(3) of the Advisers Act. Following Wiswall's receipt of the Consultant's e-mail, WSI failed to implement the statutory disclosure and consent requirements of Section 206(3) of the Advisers Act. WSI's disregard of the disclosure and consent requirements continued until at least 2008, when staff from the Commission's Office of Compliance Inspections and Examinations (the "Exam Staff") discovered the violations. Moreover, Wiswall failed to take

reasonable steps: (a) to ascertain whether WSI had written policies and procedures designed reasonably to prevent violation of Section 206(3) when WSI engaged in principal trades with its clients; and (b) to adopt and implement such policies and procedures on behalf of WSI.

***WSI Failed to Maintain Required Written Policies and Procedures and a Written Code of Ethics, and Wiswall and Wunderlich Aided and Abetted and Caused WSI's Violations***

22. For more than one year after its SEC Registration, WSI failed to comply with the mandate under Rule 206(4)-7 of the Advisers Act that every Commission-registered investment adviser adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and its rules by the adviser and its supervised persons. In addition, in early 2008, WSI failed to comply with the mandate under Rule 206(4)-7 that every Commission-registered investment adviser review at least annually the adequacy of such policies and procedures and the effectiveness of their implementation. Furthermore, for more than one year after its SEC Registration, WSI failed to comply with the mandate under Rule 204A-1 of the Advisers Act that every Commission-registered investment adviser establish, maintain, and enforce a written code of ethics that meets the minimum standards set out in the rule. WSI did not put in place written policies and procedures and a written code of ethics designed to comply with applicable regulatory requirements until after the Commission's examination staff began a review of WSI's advisory operations in April 2008.

23. WSI, at Wunderlich's direction, tasked Wiswall with responsibility for establishing and administering WSI's compliance programs. Several months before the SEC Registration, Wiswall arranged for WSI to purchase, with Wunderlich's consent, an "off the shelf" investment adviser compliance manual containing sample written policies and procedures for investment advisers (the "IA Manual"). Wiswall purchased the IA Manual to supplement WSI's manual of supervisory procedures and other written policies and procedures already in place with respect to WSI's brokerage business (the "BD Manual"). The BD Manual, however, contained virtually no compliance policies and procedures specifically relating to WSI's advisory operations.

24. From the effective date of the SEC Registration, Wiswall was responsible for revising the draft IA Manual under Wunderlich's direction so that the written compliance policies and procedures in the IA Manual reflected WSI's actual advisory business. Wiswall also was in charge of overseeing the implementation of such policies and procedures. In addition, Wiswall was responsible under Wunderlich's direction for preparing the mandatory written code of ethics on behalf of WSI that complied with the Advisers Act and its rules, and distributing the written code of ethics to appropriate WSI personnel.

25. When WSI retained the Consultant in July 2007 to assist Wiswall with respect to the firm's advisory operations, the Consultant obtained from Wiswall and reviewed the IA Manual. At that time, several months after the SEC Registration, Wiswall still had not completed the revisions to the written compliance policies and policies reflected in the draft IA Manual and Wiswall still had not distributed the required written code of ethics to appropriate WSI personnel.

26. In September 2007, the Consultant sent WSI a written report that outlined certain regulatory requirements for WSI's advisory operations and contained recommendations for compliance improvements (the "Consultant's Report"). Among other things, the Consultant's Report specifically cited Rule 206(4)-7 under the Advisers Act and recommended that WSI adopt a compliance manual of written policies and procedures tailored to WSI's advisory business after documenting a risk assessment of its advisory operations. The Consultant's Report also reminded WSI to conduct its annual review of its advisory compliance program.

27. In addition, the Consultant's Report expressly cited Rule 204A-1 under the Advisers Act, which requires among other things that WSI maintain a written code of ethics. The Consultant's Report pointed out that the rule specified certain requirements that must be included in the code of ethics, including that "access persons" must periodically report personal trading and the CCO or other designee must review such personal trading. The Consultant's Report noted that the Consultant would review WSI's ethics provisions maintained for its broker-dealer registration and modify as necessary "to comply with the Advisers Act as well as FINRA rules."

28. Both Wiswall and Wunderlich received and reviewed the Consultant's Report in or around September 2007.

29. By April 2008, when the Commission's Exam Staff arrived at WSI's offices to conduct the staff's first review of WSI's advisory operations after its SEC Registration, WSI and Wiswall still had not implemented written compliance policies and procedures or distributed a written code of ethics to appropriate WSI personnel in accordance with the Advisers Act and its rules.

30. Consequently, for more than six months after the issuance of the Consultant's Report and for more than one year after the SEC Registration, WSI did not have in place written compliance policies and procedures or a written code of ethics that complied with mandatory regulatory requirements. In particular, WSI did not have in place written compliance policies and procedures reasonably designed to detect whether fees to clients were being billed consistent with the representations set out in their written advisory client agreements. In addition, WSI did not have in place written compliance policies and procedures reasonably designed to detect and prevent violations of the disclosure and consent requirements when WSI engaged in principal trades with its clients. Furthermore, WSI failed to comply with the requirement that it review at least annually the adequacy and implementation of its written compliance policies and procedures.

31. As CEO, Wunderlich had overall responsibility for ensuring that WSI complied with regulatory mandates under the Advisers Act and its rules, including the requirements that WSI maintain adequate written compliance policies and procedures and a written code of ethics. The Consultant's Report, received by WSI and Wunderlich several months after the SEC Registration, provided notice to WSI and Wunderlich that the firm already had neglected to complete and implement required written compliance policies and procedures and a required written code of ethics in accordance with the Advisers Act and its rules. Yet, from the time of the Consultant's Report until after the Exam Staff arrived for its review in 2008, WSI failed to implement these regulatory requirements.

## D. Violations

32. As a result of the conduct described above, WSI willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client, because WSI overcharged numerous advisory clients for commissions and other transactional fees in thousands of separate transactions.

33. As a result of the conduct described above, WSI willfully violated, and Wiswall was a cause of WSI's violation of, Section 206(3) of the Advisers Act, which prohibits an investment adviser, acting as principal for its own account, from knowingly selling securities to or purchasing securities from the adviser's clients without disclosing to such clients in writing before the completion of such transactions the capacity in which the adviser is acting and obtaining the consent of the clients to such transactions.

34. As a result of the conduct described above, WSI willfully violated, and Wiswall and Wunderlich willfully aided and abetted and caused WSI's violation of, Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires an investment adviser registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons, and requires at least annual reviews of the adequacy of such policies and procedures and the effectiveness of their implementation. Proof of scienter is not required to establish a violation of Section 206(4) of the Advisers Act. *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992).

35. As a result of the conduct described above, WSI willfully violated, and Wiswall and Wunderlich willfully aided and abetted and caused WSI's violation of, Section 204A of the Advisers Act and Rule 204A-1 thereunder, which requires an investment adviser registered with the Commission to establish, maintain and enforce a written code of ethics that includes certain minimum standards and to take certain steps to monitor the personal trading of supervised persons with access to certain nonpublic information.

## E. Remedial Efforts

36. In determining to accept Respondents' Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

## F. Undertakings

37. Respondents undertake to take the following actions, as applicable.

38. Independent Compliance Consultant. WSI shall retain, within thirty (30) days of the entry of this Order, the services of an independent compliance consultant (the "Independent Consultant") that is not unacceptable to the Commission's staff. The Independent Consultant's compensation and expenses shall be borne exclusively by WSI.

39. WSI shall require that the Independent Consultant conduct periodic comprehensive reviews of WSI's supervisory, compliance, and other policies and procedures reasonably designed to detect and prevent breaches of fiduciary duty and federal securities law violations by WSI and its employees (the "Reviews"), including: (a) conflicts and other compliance factors creating risk exposure for WSI and its advisory clients in light of WSI's particular operations; (b) WSI's policies and procedures required by Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, including policies and procedures designed to detect and prevent fee overcharges to advisory clients; (c) WSI's policies and procedures designed to detect and prevent violations of the disclosure and consent requirements of Section 206(3) of the Advisers Act to the extent that WSI engages in principal trades with advisory clients; and (d) the adequacy of WSI's written code of ethics and WSI's compliance with the requirements of Section 204A of the Advisers Act and Rule 204A-1 thereunder.

40. During the three (3) year period beginning on the date of entry of this Order, WSI shall require the Independent Consultant to conduct its Reviews at least quarterly for the first year of review and at least twice per year for each of the second and third years of review.

41. WSI shall provide to the Commission's staff, within thirty (30) days of retaining the Independent Consultant, a copy of an engagement letter detailing the Independent Consultant's responsibilities, which shall include the Reviews to be made by the Independent Consultant as described in this Order.

42. WSI shall require that, within forty-five (45) days of the end of the applicable quarterly or semi-annual review period, the Independent Consultant shall submit a written and dated report of its findings to WSI and to the Commission's staff (the "Report"). WSI shall require that each Report include a description of the review performed, the names of the individuals who performed the review, the conclusions reached, the Independent Consultant's recommendations for changes in or improvements to WSI's policies and procedures and/or disclosures to clients, and a procedure for implementing the recommended changes in or improvements to WSI's policies and procedures and/or disclosures.

43. WSI shall adopt all recommendations contained in each Report within sixty (60) days of the applicable Report; provided, however, that within forty-five (45) days after the date of the applicable Report, WSI shall in writing advise the Independent Consultant and the Commission's staff of any recommendations that WSI considers to be unduly burdensome, impractical, or inappropriate. With respect to any recommendation that WSI considers unduly burdensome, impractical or inappropriate, WSI need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose.

44. As to any recommendation with respect to WSI's policies and procedures on which WSI and the Independent Consultant do not agree, WSI and the Independent Consultant shall attempt in good faith to reach an agreement within sixty (60) days after the date of the applicable Report. Within fifteen (15) days after the conclusion of the discussion and evaluation by WSI and the Independent Consultant, WSI shall require that the Independent Consultant inform WSI and the Commission's staff in writing of the Independent Consultant's final determination concerning any recommendation that WSI considers to be unduly burdensome, impractical, or

inappropriate. WSI shall abide by the determinations of the Independent Consultant and, within sixty (60) days after final agreement between WSI and the Independent Consultant or final determination by the Independent Consultant, whichever occurs first, WSI shall adopt and implement all of the recommendations that the Independent Consultant deems appropriate.

45. Within ninety (90) days of WSI's adoption of all of the recommendations in a Report that the Independent Consultant deems appropriate, as determined pursuant to the procedures set forth herein, WSI shall certify in writing to the Independent Consultant and the Commission's staff that WSI has adopted and implemented all of the Independent Consultant's recommendations in the applicable Report. Unless otherwise directed by the Commission's staff, all Reports, certifications, and other documents required to be provided to the Commission's staff shall be sent to Aaron W. Lipson, Assistant Regional Director, Securities and Exchange Commission, 3475 Lenox Road, N.E., Suite 1000, Atlanta, Georgia 30326, or such other address as the Commission's staff may provide.

46. WSI, Wunderlich, and Wiswall shall cooperate fully with the Independent Consultant and shall provide the Independent Consultant with access to such of their files, books, records, and personnel as are reasonably requested by the Independent Consultant for review.

47. To ensure the independence of the Independent Consultant, WSI: (a) shall not have the authority to terminate the Independent Consultant or substitute another independent compliance consultant for the initial Independent Consultant, without the prior written approval of the Commission's staff; and (b) shall compensate the Independent Consultant and persons engaged to assist the Independent Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

48. WSI shall require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two (2) years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with WSI, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Independent Consultant will require that any firm with which the Independent Consultant is affiliated or of which the Independent Consultant is a member, and any person engaged to assist the Independent Consultant in the performance of the Independent Consultant's duties under this Order shall not, without prior written consent of the Commission's staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with WSI, 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 (2) years after the engagement.

49. Recordkeeping. WSI shall preserve for a period of not less than six (6) years from the end of the fiscal year last used, the first two (2) years in an easily accessible place, any record of WSI's compliance with the undertakings set forth in this Order.

50. Notice to Advisory Clients. Within ten (10) days of the entry of this Order, WSI shall post prominently on its principal website a summary of this Order in a form and location acceptable to the Commission's staff, with a hyperlink to the entire Order. WSI shall maintain the

posting and hyperlink on WSI's website for a period of twelve (12) months from the entry of this Order. Within thirty (30) days of the entry of this Order, WSI shall provide a copy of the Order to each of WSI's existing advisory clients as of the entry of this Order via mail, e-mail, or such other method as may be acceptable to the Commission's staff, together with a cover letter in a form not unacceptable to the Commission's staff. Furthermore, for a period of twelve (12) months from the entry of this Order, to the extent that WSI is required to deliver a brochure to a client and/or prospective client pursuant to Rule 204-3 of the Advisers Act, WSI shall also provide a copy of this Order to such client and/or prospective client at the same time that WSI delivers the brochure.

51. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates relating to the undertakings. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

52. Certifications of Compliance by Respondents. Respondents shall each certify, in writing, compliance with their respective undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission's staff may make reasonable requests for further evidence of compliance, and Respondents each agree to provide such evidence. The certification and supporting material shall be submitted to Aaron W. Lipson, Assistant Regional Director, Securities and Exchange Commission, 3475 Lenox Road, N.E., Suite 1000, Atlanta, Georgia 30326, or such other address as the Commission's staff may provide, 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.

## IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act with respect to WSI, and pursuant to Section 15(b) of the Exchange Act and Sections 203(f) and 203(k) of the Advisers Act with respect to Wiswall and Wunderlich, it is hereby ORDERED that:

A. WSI cease and desist from committing or causing any violations and any future violations of Sections 204A, 206(2), 206(3), and 206(4) of the Advisers Act and Rules 204A-1 and 206(4)-7 promulgated thereunder.

B. Wiswall cease and desist from committing or causing any violations and any future violations of Sections 204A, 206(3), and 206(4) of the Advisers Act and Rules 204A-1 and 206(4)-7 promulgated thereunder.

C. Wunderlich cease and desist from committing or causing any violations and any future violations of Sections 204A and 206(4) of the Advisers Act and Rules 204A-1 and 206(4)-7 promulgated thereunder.

D. WSI, Wiswall, and Wunderlich are censured.

E. WSI shall pay disgorgement and prejudgment interest as follows:

(1) WSI shall pay disgorgement of $369,336.15 (representing the amount of the Remaining Principal Trade Compensation as defined in this Order) and prejudgment interest of $38,288.54, consistent with the provisions of this Subsection E. Within sixty (60) days of the entry of this Order, WSI shall deposit the full amount of the disgorgement (the "Disgorgement Fund") into an escrow account acceptable to the Commission's staff and WSI shall provide the Commission's staff with evidence of such deposit in a form acceptable to the Commission's staff. In addition, within ten (10) days of the entry of this Order, WSI shall pay the full amount of the prejudgment interest to the Commission for transmittal to the United States Treasury, in the manner provided in paragraph (6) below of this Subsection E. If timely deposit of the Disgorgement Fund or timely payment of the prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

(2) WSI shall be responsible for administering the Disgorgement Fund. WSI shall pay applicable portions of the Disgorgement Fund to affected current and former advisory clients who engaged in the Relevant Principal Trades, pursuant to a disbursement calculation (the "Calculation") that has been submitted to, reviewed and approved by the Commission's staff in accordance with this Subsection E. If the total amount otherwise payable to a client is less than $25.00, WSI shall instead pay such amount to the Commission for transmittal to the United States Treasury as provided in this Subsection E.

(3) WSI shall, within thirty (30) days from the entry of this Order, submit a proposed Calculation to the Commission's staff for its review and approval that identifies, at a minimum: (1) the name and account number of each affected advisory client; (2) the exact amount of the payment to be made to such client, consisting of the amount of the Remaining Principal Trade Compensation applicable to such client's Relevant Principal Trade, separately identifying commissions and mark-ups or mark-downs received by WSI; (3) the exact amount of any portion of the Remaining Principal Trade Compensation that WSI claims already has been paid to such client in anticipation of this Order, along with supporting proof of such advance payment; and (4) a description of the Relevant Principal Trade to which the client's payment relates. WSI also shall provide to the Commission's staff such additional information and supporting documentation relating to the Remaining Principal Trade Compensation as the Commission's staff may request for the purpose of its review. No portion of the Disgorgement Fund shall be paid to any client account directly or indirectly in the name of or for the benefit of Wiswall or Wunderlich. In the event of one or more objections by the Commission's staff to WSI's proposed Calculation and/or any of its information or supporting documentation, WSI shall submit a revised Calculation for the review and approval of the Commission's staff and/or additional information or supporting documentation within ten (10) days of the date that WSI is notified of the objection, which revised Calculation shall be subject to all of the provisions of this Subsection E.

(4) WSI shall complete the transmission of all amounts otherwise payable to affected advisory clients pursuant to a Calculation approved by the Commission's staff within one hundred and twenty (120) days of the entry of this Order, unless such time period is extended as provided in paragraph (10) below of this Subsection E.

(5) WSI has indicated to the Commission's staff a willingness to begin paying amounts to affected advisory clients in advance of this Order that otherwise would be payable through the Disgorgement Fund. Any such amount that WSI pays to an affected advisory client in advance of this Order shall be credited against the total amount to be paid by WSI from the Disgorgement Fund and shall be returned to WSI from the Disgorgement Fund, but only if such payment is reviewed and approved by the Commission's staff in accordance with this Order and WSI provides information and supporting documentation acceptable to the Commission's staff as proof of such payment.

(6) If WSI does not distribute or return any portion of the Disgorgement Fund for any reason, including an inability to locate an affected advisory client or any factors beyond WSI's control, or if WSI has not transferred any portion of the Disgorgement Fund to a client because that client is due less than $25.00, WSI shall transfer any such undistributed funds to the Commission for transmittal to the United States Treasury after the final accounting provided for in this Subsection E is approved by the Commission. Any such payment shall be: (1) made by wire transfer, 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, 100 F St., N.E., Stop 6042, Washington, DC 20549; and (4) submitted under cover letter that identifies WSI, Wiswall, and Wunderlich as Respondents in these proceedings, and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Aaron W. Lipson, Assistant Regional Director, Securities and Exchange Commission, 3475 Lenox Road, N.E., Suite 1000, Atlanta, Georgia 30326, or such other address as the Commission's staff may provide.

(7) WSI shall be responsible for any and all tax compliance responsibilities associated with the Disgorgement Fund and may retain any professional services necessary or appropriate. The costs and expenses of any such professional services shall be borne by WSI and shall not be paid out of the Disgorgement Fund.

(8) Within one hundred and eighty (180) days after the date of entry of this Order, WSI shall submit to the Commission's staff for its approval a final accounting and certification of the disposition of the Disgorgement Fund, which final accounting and certification shall be in a format to be provided by the Commission's staff. The final accounting and certification shall include, but not be limited to: (1) the amount paid to each payee; (2) the date of each payment; (3) the check number or other identifier of money transferred; (4) the date and amount of any returned payment; (5) a description of any effort to locate a prospective payee whose payment was returned or to whom payment was not made for any reason; (6) any amounts to be forwarded to the Commission for transfer to the United States Treasury; and (7) an affirmation that the Remaining Principal Trade Compensation, plus any related amounts that WSI claims to have been refunded to affected advisory clients before the date of this Order, represents a fair and reasonable calculation of the compensation received by WSI from February 2007 through September 2009 with respect to the Relevant Principal Trades for which WSI failed to satisfy the disclosure and consent requirements mandated by Section 206(3) of the Advisers Act. WSI shall submit proof and supporting documentation of such payment (whether in the form of cancelled checks or otherwise) in a form acceptable to the Commission's staff and under a cover letter that identifies WSI, Wiswall, and Wunderlich as Respondents in these proceedings and the file number

of these proceedings, to Aaron W. Lipson, Assistant Regional Director, Securities and Exchange Commission, 3475 Lenox Road, N.E., Suite 1000, Atlanta, Georgia 30326, or such other address as the Commission's staff may provide. WSI shall provide any and all supporting documentation for the accounting and certification to the Commission's staff upon its request, and shall cooperate with any additional requests by the Commission's staff in connection with the accounting and certification.

(9) After WSI has submitted the final accounting to the Commission's staff, the staff shall submit the final accounting to the Commission for approval and shall request Commission approval to send any remaining amount to the United States Treasury.

(10) The Commission's staff may extend any of the procedural dates set forth in this Subsection E for good cause shown. Deadlines for dates relating to the Disgorgement Fund shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

F. WSI shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $125,000 to the United States Treasury. Wiswall shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $50,000 to the United States Treasury. Wunderlich shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $45,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Such payment shall be: (a) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Securities and Exchange Commission; (c) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, 100 F St., N.E., Stop 6042, Washington, DC 20549; and (d) submitted under cover letter that identifies WSI, Wiswall, and Wunderlich as Respondents in these proceedings, and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Aaron W. Lipson, Assistant Regional Director, Securities and Exchange Commission, 3475 Lenox Road, N.E., Suite 1000, Atlanta, Georgia 30326, or such other address as the Commission's staff may provide.

G. WSI, Wiswall, and Wunderlich shall comply with their respective undertakings enumerated in Section III, Subsection F, above.

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
Rel. No. 64557 / May 27, 2011

Admin. Proc. File Nos. 3-14307 and 3-14308

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| In the Matter of the Application of<br><br>WORLD TRADE FINANCIAL CORP., JASON TROY ADAMS, FRANK EDWARD BRICKELL, and RODNEY PRESTON MICHEL<br><br>For Review of Disciplinary Action Taken by FINRA | ORDER DENYING CONSOLIDATION |
| In the Matter of the Application of<br><br>MIDAS SECURITIES, LLC, and JAY S. LEE<br><br>For Review of Disciplinary Action Taken by FINRA | |

On March 3, 2011, the Financial Industry Regulatory Authority ("FINRA") issued a decision in a disciplinary action that involved Applicants in the above-captioned matters.[1] FINRA's decision found that FINRA member firms World Trade Financial Corp. ("World Trade") and Midas Securities, LLC ("Midas Securities"), and Frank Edward Brickell, an associated person of World Trade, sold unregistered shares of iStorage Networks, Inc. ("iStorage"), stock in violation of Section 5 of the Securities Act of 1933 and NASD Rule 2110.

In connection with these violations, FINRA found that World Trade and its principals Rodney Preston Michel and Jason Troy Adams violated NASD Rules 3010 and 2110 by failing to maintain adequate written supervisory procedures and failing to supervise the registered representatives who were participating in the unregistered securities sales. FINRA also found that Midas Securities and its principal Jay S. Lee committed similar supervisory violations. It

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[1] *Dep't of Enforcement v. Midas Sec., LLC, World Trade Fin. Corp., Jason Troy Adams, Frank Edward Brickell, Jay S. Lee, and Rodney Preston Michel*, Complaint No. 2005000075703 (FINRA NAC decision Mar. 3, 2011), 2011 WL 786035.

fined World Trade $45,000, Midas Securities $80,000, Brickell $15,000, Michel $30,000, Adams $20,000, and Lee $50,000 and suspended Brickell, Adams, and Lee for their misconduct.

On March 24, 2011, World Trade, Brickell, Michel, and Adams (the "World Trade Applicants") and Midas Securities and Lee (the "Midas Securities Applicants") filed separate petitions for review of FINRA's decision, and the Commission's Office of the Secretary designated the two proceedings as separate appeals. On April 15, 2011, FINRA filed a motion to consolidate the two proceedings, arguing that, with limited exception, the separate petitions for review "contain nearly identical challenges to FINRA's findings of fact, conclusions of law, and sanctions imposed in the March 3 Decision."

On April 28, 2011, the World Trade Applicants and the Midas Securities Applicants filed oppositions to FINRA's motion, claiming, among other things, that the two firms "are wholly unrelated," "were not working together, [and] were not involved in the same transactions," and that the only commonality between them is that they both have been charged by FINRA with the unregistered sale of the same security. Applicants assert that "each firm has a different set of circumstances" with respect to the sanctions imposed and that they "will be prejudiced" if the matters are consolidated.

Commission Rule of Practice 201(a) provides that we may order consolidation of proceedings "involving a common question of law or fact."[2] Our initial examination of FINRA's decision suggests that, although FINRA alleges similar violations with respect to the sale of iStorage shares, each of the individual allegations is based on distinct facts that are specific to each firm.[3] There is no claim of any relationship between the firms or that the firms acted in concert in connection with the alleged sales. Moreover, the facts and issues relating to the supervisory allegations differ with each firm and associated person involved. Under the circumstances, we do not believe our review of FINRA's disciplinary action will benefit from consolidation of the proceedings.

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[2] 17 C.F.R. § 201.201(a).

[3] *See Frank J. Custable, Jr.*, Order Denying Consolidation, Admin. Proc. File Nos. 3-7742 and 3-7899 (Jan. 7, 1993) (denying consolidation of proceedings, despite involving the same individual and "similar violations," because, among other reasons, of the "distinct facts" underlying the allegations).

Accordingly, it is ORDERED that the request of FINRA for consolidation of the above-titled proceedings be, and it hereby is, denied.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter
Commissioner Aguilar
not participating

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

**SECURITIES ACT OF 1933**
**Release No. 9213 / May 27, 2011**

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| In the Matter of<br><br>**UBS FINANCIAL SERVICES INC.**<br><br>Respondent. | **ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE DISQUALIFICATION PROVISIONS OF RULES 602(b)(4) AND 602(c)(2)** |

UBS Financial Services Inc. ("UBS") has submitted a letter, dated April 13, 2011, requesting a waiver of the disqualification from the exemption from registration under Regulation E arising from the settlement with the Commission of a civil injunctive proceeding.

On May 4, 2011, the Commission filed a civil injunctive complaint against UBS in the United States District Court for the District of New Jersey alleging that UBS violated Section 15(c)(1)(A) of the Securities Exchange Act of 1934 ("Exchange Act").

Pursuant to an Offer of Settlement from UBS, UBS simultaneously filed a "Consent of UBS Financial Services Inc." in which it agreed, without admitting or denying the allegations of the Commission's complaint, to the entry of a Final Judgment against it. Among other things, the Final Judgment permanently enjoins UBS from violating Section 15(c)(1)(A) of the Exchange Act, orders UBS to pay $47, 207,180 million in disgorgement, penalties and interest. In its complaint, the Commission alleges that UBS was involved a bid-rigging scheme related to tax-exempt municipal securities.

Rule 602(b)(4) makes the Regulation E exemption unavailable to an issuer if, among other things, such issuer or any of its affiliates is subject to any "order, judgment, or decree of any court of competent jurisdiction, entered within five years prior to the filing of such [Regulation E] notification, temporarily or permanently restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of securities." Rule 602(c)(2) also makes the exemption unavailable to an issuer if, among other things, any underwriter of the securities to be issued is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser." Rule 602(e) provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied."

Based on the representations set forth in UBS' April 13, 2011 request, the Commission has determined that, pursuant to Rule 602(e), a showing of good cause has been made and that it is not necessary under the circumstances that the exemption be denied as a result of the Final Judgment or as a result of any related injunction entered by a U.S. state or territorial court addressing the same activities as the settled injunctive proceeding.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act of 1933 ("Securities Act"), that a waiver of the disqualification provisions of Rules 602(b)(4) and 602(c)(2) under the Securities Act resulting from the entry of the Final Judgment is hereby granted.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter
Commissioner Aguilar
not participating

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

**SECURITIES ACT OF 1933**
**Release No. 9212 / May 27, 2011**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64559 / May 27, 2011**

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| In the Matter of<br><br>**UBS FINANCIAL SERVICES INC.**<br><br>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** |

UBS Financial Services Inc. ("UBS") has submitted a letter on behalf of themselves and any of their current and future affiliates, dated April 13, 2011, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from its settlement of an injunctive action instituted by the Commission.

On May 6, 2011, pursuant to a consent filed by UBS, the Honorable William J. Martini, United States District Court Judge for the District of New Jersey in Securities and Exchange Commission v. UBS Financial Services Inc. (Case No. 11-cv-02539-WJM) entered a final judgment against UBS (the "Final Judgment"). The Final Judgment enjoined UBS from violating, directly or indirectly, Exchange Act Section 15(c)(1)(A) and required that UBS pay disgorgement plus prejudgment interest and civil money penalties in the total amount of $47,207,180.

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the

Commission." Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in UBS's April 13, 2011 request, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Final Judgment is appropriate and should be granted.

Accordingly, IT IS ORDERED, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to UBS and any current or future affiliates resulting from the Final Judgment is hereby granted.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro
Commissioner Walter
Commissioner Paredes
not participating

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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64568 / May 31, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-11359**

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| **In the Matter of**<br><br>**Alliance Capital Management, LP**<br><br>**Respondent.** | **ORDER DIRECTING DISBURSEMENT OF FAIR FUND** |

On March 13, 2008, the Commission published a Notice of the Plan of Distribution ("Plan") proposed by the Division of Enforcement in connection with this proceeding (Securities Exchange Act Release No. 57489). The Commission received no comments and on May 15, 2008, the Plan was approved (Exchange Act Release No. 57825).

The Plan provides that a Fair Fund consisting of disgorgement and civil penalties, plus any accrued interest, be transferred to Deutsche Bank to be distributed by the Fund Administrator to injured investors according to the methodology set forth in the Plan.[1] To date, $341,982,093.86 has been disbursed in six tranches.[2] The Plan provides that the Commission

1 The $321,230,003 Fair Fund amount comprises the $250 million from the Alliance Settlement, the $70.38 million from the Calugar Settlement, and the total of $850,003 paid by Malone, Carifa and Laughlin, as described in the Order approving the Plan. *See* Exchange Act Rel. No. 57825.

2 By Order Directing Disbursement of Fair Fund dated January 22, 2009, the Commission ordered the first disbursement, composed of $46,166,264.96. *See* Exchange Act Rel. No. 59280. By Order Directing Disbursement of Fair Fund dated February 11, 2009, the Commission ordered the second disbursement, composed of $79,178,672.81. *See* Exchange Act Rel. No. 59389. By Order Directing Disbursement of Fair Fund dated March 31, 2009, the Commission ordered the third disbursement, composed of $63,141,852.24. *See* Exchange Act Rel. No. 59657. By Order Directing Disbursement of Fair Fund dated April 28, 2009, the Commission ordered the fourth disbursement, composed of $49,910,496.49. *See* Exchange Act Rel. No. 59832. By Order Directing Disbursement of Fair Fund dated May 14, 2009, the Commission ordered the fifth disbursement, composed of $56,642,634.13. *See* Exchange Act Rel. No.

will arrange for distribution of the Fair Fund when a Payee List listing the payees with the identification information required to make the distribution has been received and accepted. The Payee List for the seventh tranche of distribution in the amount of $9,738,605.02 has been received and accepted. This Payee List is composed of corrective payments to those injured investors who were underpaid in prior tranches.

Accordingly, it is ORDERED that the Commission staff shall transfer $4,371,089.55 from the SEC to Deutsche Bank and the Fund Administrator shall distribute $9,738,605.02 to injured investors, as provided for in the Plan of Distribution.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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59926. By Order Directing Disbursement of Fair Fund dated August 5, 2009, the Commission ordered the sixth disbursement, composed of $46,942,173.23. *See* Exchange Act Rel. No. 60446.

Commissioner Walter not participating

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

**SECURITIES ACT OF 1933**
**Release No. 9214 / May 31, 2011**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 64572 / May 31, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3212 / May 31, 2011**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 29685 / May 31, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14404**

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|---|---|
| **In the Matter of**<br><br>**Belsen Getty, LLC, Terry M. Deru, and Andrew W. Limpert,**<br><br>**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** |

**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 ("Investment Company Act") against Belsen Getty, LLC ("Belsen Getty"), Terry M. Deru ("Deru"), and Andrew W. Limpert ("Limpert") (collectively "Respondents").

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Respondent Belsen Getty, incorporated in Nevada in 1982, has been an investment adviser registered with the Commission since September 1, 1982. Belsen Getty was reorganized as a Utah limited liability company in 1998 and is now headquartered in Bountiful, Utah. From approximately 2002 to 2007, Belsen Getty was owned and controlled by Prime Resource, Inc. ("Prime Resource"), a public company formed by Belsen Getty principals. As of November 19, 2008, Belsen Getty managed approximately 950 client accounts and approximately $65,000,000 in assets. As of December 31, 2010, Belsen Getty managed $47,662,998 in assets in 557 client accounts. Belsen Getty exercises discretionary trading authority over its client accounts.

2. Respondent Deru is the Managing Member and Chief Compliance Officer of Belsen Getty. He is an investment adviser representative, and a direct owner and control person of Belsen Getty. Deru was an officer and director of Prime Resource when it was a public company during approximately 2002 to 2007. Deru, 56 years old, is a resident of Layton, Utah. Deru participated in an offering of Nine Mile Software, Inc. ("Nine Mile") stock, which is a penny stock.

3. Respondent Limpert was a former Member, direct owner and control person of Belsen Getty from 2004 until December 2008. He is an investment adviser representative. Limpert is the Chairman of the Board of Nine Mile and CFO of ProFire Energy, Inc. ("ProFire"), both publicly traded companies. Limpert was an officer and director of Prime Resource when it was a public company during approximately 2002 to 2007. Limpert, 41 years old, is a resident of Sandy, Utah. Limpert participated in an offering of Nine Mile stock, which is a penny stock.

B. OTHER RELEVANT ENTITIES AND INDIVIDUALS

1. Nine Mile, incorporated in Nevada on November 30, 2006, is engaged in the business of developing and marketing specialized software for the financial and brokerage industry. Nine Mile is headquartered in Layton, Utah. It has a reporting obligation pursuant to Section 15(d) of the Exchange Act. Nine Mile stock is a penny stock.

2. Damon Deru is the CEO and a Director of Nine Mile. Damon Deru was associated with Belsen Getty as an investment adviser representative until March 5, 2008. Damon Deru is Deru's son and worked at Belsen Getty from 2000 until December 2008.

## C. FRAUD IN THE OFFER OR SALE OR IN CONNECTION WITH THE PURCHASE OR SALE OF SECURITIES

### Misrepresentations or Omissions Related to Nine Mile

1. In 2006, while employed by Belsen Getty, Deru, Limpert, and Damon Deru founded Nine Mile. In August 2007, Nine Mile issued 1,882,000 shares of restricted stock in an unregistered private offering, relying on the registration exemption pursuant to Rule 504 of Regulation D. Deru and Limpert each owned 31.9% (600,000 shares) of the total, and Damon Deru owned 10.6% (200,000 shares). Damon Deru became the CEO and Director, and Limpert became the Chairman of the Board of Directors.

2. In November 2007, Nine Mile commenced an initial public offering ("IPO") of stock. Belsen Getty, through Deru and Limpert, recommended Nine Mile to its clients. By September 30, 2008, Nine Mile had raised $388,421 and issued a total of 714,288 shares at $0.70 per share. The vast majority of IPO shares (92%) were sold to Belsen Getty clients. In recommending Nine Mile stock to clients, Belsen Getty, through Deru and Limpert, failed to disclose that Belsen Getty exercised discretionary trading authority over, and thus controlled, 92% of the outstanding non-restricted Nine Mile stock. Deru and Limpert knew or were reckless in not knowing that Belsen Getty's control of the stock was a material fact that investors would want to know before investing.

### Market Manipulation of Nine Mile Stock

3. By October 2008, Nine Mile had obtained a market maker and a trading symbol for its stock, but the stock was not publicly quoted by any of the major quotation systems.

4. Between October 22, 2008 and November 7, 2008, Belsen Getty, through Deru, initiated sell orders and buy orders of Nine Mile stock. Deru ordered the trades for individual Belsen Getty clients using Belsen Getty's discretionary authority and without informing clients of risk or conflicts of interest. Damon Deru placed orders for the trades using Belsen Getty's block trading account, then allocated the block trades into or out of individual client accounts.

5. The buy and sell sides of the transactions in Nine Mile were not identical (e.g., wash trades), but the amounts on each side of the transactions were very similar. Most or all of the trading volume in Nine Mile during this period consisted of the trading by Belsen Getty and corresponding trades by the market maker who acquired shares to fill Belsen Getty's orders.

6. Belsen Getty, through Deru, was aware of the transactions and knew or was reckless in not knowing that this trading manipulated the market for Nine Mile stock. Deru placed orders for transactions on behalf of Belsen Getty while he knew or was reckless in not knowing the trades were manipulative.

7. After the trades were placed, Nine Mile stock began to be publicly quoted at $0.82, the price of the last trade initiated by Belsen Getty. By placing these orders on both sides of the transactions, Belsen Getty, through Deru, was able to artificially set the price higher than the $0.70 IPO price and create the artificial appearance of trading volume and investor interest. Deru knew or was reckless in not knowing the trading manipulated the market for Nine Mile stock.

Misrepresentations or Omissions Related to Axxess Funding Group, LLC

8. In January 2005, Deru, Limpert, and Damon Deru formed Axxess Funding Group, LLC ("Axxess"), to engage in the business of secured real estate lending. Deru is the managing member, and Limpert and Damon Deru are the only other managing members.

9. Belsen Getty, through Deru and Limpert, recommended Axxess to Belsen Getty clients and raised approximately $3 million from 70-80 investors (all Belsen Getty clients) through two private offerings, one in 2005 and one in 2007-08.

10. The Private Placement Memoranda ("PPMs") for both offerings represented that Deru, Limpert, and Damon Deru would manage the company, vote on decisions, that each of them had extensive education and experience qualifying them for managing the company, and that they would be compensated for their work by charging Axxess a management fee of 2% of gross revenues as well as a share of profits. Contrary to these representations, Deru managed the company and used investor funds without input from Limpert and Damon Deru. Instead, Deru hired his high-school educated son to perform many of the functions that were supposed to be performed by the members and for which the members received compensation. Limpert failed to conduct due diligence or vote on investment decisions, as represented by the PPMs. Deru and Limpert knew or were reckless in not knowing these material facts and failed to disclose them to investors.

11. During 2007 and 2008, Deru arranged for Axxess to pay his son undisclosed fees (close to $300,000, almost ten percent of the money raised in the two offerings) for what appeared to be very little work and for work that should have been completed by the member managers and compensated by the management fee and profits already being paid to the member managers. In addition, Deru used investor funds to loan himself up to $500,000 for his personal benefit. Although Axxess' Operating Agreement allowed it to make loans to members, the Operating Agreement required unanimous consent of all members prior to a loan. Deru did not inform members of this loan and did not obtain consent from any members. Limpert knew or was reckless in not knowing these material facts, as he was supposed to participate in management and loan decisions, according to the PPMs.

12. Belsen Getty, through Deru and Limpert, failed to disclose these material facts about Axxess to investors. Belsen Getty, through Deru, also failed to provide

a PPM to at least one client and failed to disclose material conflicts of interest and that Axxess was a high-risk, illiquid investment.

Misrepresentations or Omissions Related to Vermillion Holdings

13. In early 2009, Deru recommended to a Belsen Getty client, that the client invest in a Nevada corporation called Vermillion Holdings Ltd. ("Vermillion Holdings"), which Deru falsely represented owned a gold mine located in Mexico. After giving Deru a $1 million investment, the client learned that Vermillion Holdings had no rights to the gold mine and that the mine was actually owned by a Mexican company, which was 99% owned by Deru. The client also learned that the mine was out of money and had significant unpaid bills for taxes, contractors, rental companies, and payroll.

14. Deru failed to disclose these material facts to the client and the client's family members, who also invested in Vermillion Holdings. Deru later ceded 72% ownership of the Mexican entity to the client, after admitting that $100,000-$200,000 of investor funds had been transferred to an entity that had nothing to do with Vermillion Holdings or the Mexican entity.

Misrepresentations or Omissions Related to Flooring Zone/ProFire

15. In or around early 2008, Deru and Limpert purchased, in a private sale, restricted stock in Flooring Zone, Inc., a public shell company. Deru and Limpert set up a reverse merger with a private entity, and renamed the public company, ProFire. Limpert has been Chief Financial Officer of ProFire since the merger.

16. In March 2008, Belsen Getty, through Deru, recommended to a 63-year-old Belsen Getty client, that he purchase what was in fact Deru's personal, restricted stock. Deru falsely represented that the stock had a potential rate of return of 33% to 50%, and that it would be a quick turnaround on the investment. Deru failed to disclose material facts to the investor, specifically that Deru set the price for the stock arbitrarily and that non-restricted stock was available for purchase on the open market, possibly at a lower price. Deru withdrew $50,000 from the client's brokerage account and paid it directly to himself. While acting as a principal for his own account, Deru failed to disclose in writing that Deru was acting in that capacity and failed to obtain the client's consent prior to completion of the transaction.

D. BREACH OF FIDUCIARY DUTY

1. Belsen Getty, through Deru, recommended high-risk, speculative, and illiquid investments to Belsen Getty clients, even though the investments did not match the clients' investment objectives. Belsen Getty, through Deru, completed many purchases for clients using Belsen Getty's discretionary authority and did not disclose material conflicts of interest, namely that Deru, Limpert, and/or Deru's family members had a financial interest in these investments. These high-risk investments included Nine Mile, Axxess, and ProFire.

2. A 70-year-old client wanted conservative management of his funds, and testified that he and Deru agreed not to invest in any high-risk investments because he was too close to retirement to do anything risky. In spite of this, Deru purchased $7,000 of Nine Mile stock for the client's account, without disclosing risk or conflicts of interest.

3. A 70-year-old retired client discussed with Deru that she and her husband preferred low-risk investments, especially as they had gotten older and closer to retirement. In spite of this, Deru purchased $6,527.48 of Nine Mile stock for the client's account without disclosing risk or conflicts of interest.

4. A 62-year-old client discussed with Deru that he wanted only conservative investments. When Deru approached the client, he told Deru he was not interested in Nine Mile or penny stocks and did not want to have anything to do with the stock market. In spite of this and even though Deru knew Nine Mile was an illiquid investment, Deru falsely represented to the client that this was a very good deal where the client could make a return very quickly, in a matter of three or four months because the market makers would buy him out at a good profit once trading started. Based on Deru's representations that the investment would be a quick turnaround, the client agreed to invest $100,000 in Nine Mile.

5. A 77-year-old client's objective was protection of capital and being conservative with his investments. Deru purchased close to $10,000 in Nine Mile stock in the client's account without disclosing risk or any facts setting forth conflicts of interest. The client questioned Deru about it when he saw the purchase on his statement. Deru gave the client an oral description about Nine Mile and was able to allay concerns he had about the purchase by representing it was a good investment. However, after learning of this investigation, the client looked up and read Nine Mile's public filings, and determined that Deru's purchase of the stock in the client's account was inconsistent with the client's investment objectives. The client eventually left Belsen Getty because of the situation.

6. A 64-year-old client was retired, divorced, and on a fixed income when she became a Belsen Getty client. Deru advised the client that at her age, she should keep her assets liquid in case she needed them. In spite of this, Deru purchased Axxess securities, which were both restricted and illiquid, for the client's account, without disclosing risks or any facts setting forth conflicts of interest. The client was an unsophisticated investor, who trusted Deru to take care of her investments because she knew nothing about investing.

7. A 63-year-old client informed Deru that he wanted conservative investments and wanted Deru to discuss any riskier investments prior to investing. In spite of this, Deru invested in Nine Mile stock for the client without disclosing risk or any facts setting forth conflicts of interest. Deru also recommended Axxess, which was a high-risk, illiquid investment. Deru convinced the client to purchase restricted ProFire stock personally owned by Deru, but did not disclose that non-restricted ProFire stock was available through the public market, possibly at a lower price.

## E. OMITTING REQUIRED INFORMATION IN FORMS ADV AND FAILURE TO MAINTAIN REQUIRED RECORDS

1. In Forms ADV signed and filed by Deru on behalf of Belsen Getty, Deru omitted to state material facts required to be stated on Schedule B to Part IA. Specifically, Deru failed to disclose that he and Limpert were the owners and managers of Prime Advisors, LLC, the parent company to Belsen Getty. In addition, in its Form ADV Part II, Item 9.D, Deru disclosed that Belsen Getty or related persons recommend to clients securities or investments in which Belsen Getty or related persons have financial interest, but failed to describe in Schedule F, as required, when it or a related person engages in such transactions and what restrictions, internal procedures, or disclosures are used for conflicts of interest in those transactions. Schedule F also failed to disclose that Belsen Getty would use its discretionary trading authority to effect transactions in such securities. Even after being informed of these failures by Commission staff, Deru failed to update or amend the Forms ADV to include correct information. The Form ADV also failed to disclose in Part II, Item 9.A or Schedule F, as required, that Belsen Getty or its related persons bought or sold personal securities to clients.[1]

2. Belsen Getty, through Deru and Limpert, failed to maintain records of the recommendation and purchase of Nine Mile stock for clients. The only documentation showing that clients had invested in Nine Mile was the transaction detail when the client sold the security in the open market. Deru and Limpert knew or were reckless in not knowing that their acts and omissions contributed to Belsen Getty's failure to maintain the required records.

## F. FAILURE TO MAINTAIN AND ENFORCE WRITTEN INSIDER TRADING POLICIES AND PROCEDURES, A WRITTEN CODE OF ETHICS, AND WRITTEN POLICIES AND PROCEDURES REASONABLY DESIGNED TO PREVENT VIOLATION OF THE ADVISERS ACT

1. Belsen Getty, through Deru, used a template from a compliance service provider to draft its Code of Ethics and Policies and Procedures Manual. Deru, as Chief Compliance Officer, was directly responsible for writing, updating, and enforcing Belsen Getty's written policies and procedures.

2. Deru failed to adapt the template to Belsen Getty's specific practices and failed to adopt policies to address conflicts of interest associated with recommending investments in which its associated persons have a financial interest. Even after being informed by Commission staff of this failure, Belsen Getty, through Deru, failed to adapt or revise its policies. Limpert, a principal of Belsen Getty, failed to ensure written policies

[1] Item numbers are to the Form ADV prior to Part II's amendment effective October 12, 2010.

and procedures were adequate and enforced, even though he read and reviewed the policies and procedures.

3. Belsen Getty, through Deru and Limpert, failed to follow or enforce its own policies and procedures to prevent insider trading. Belsen Getty's Code of Ethics states it will place a company's securities on a "restricted list" or "watch list" when employees possess material, non-public information about the company. In addition, the Code of Ethics states that where its employees serve on the board of directors of a public company, Belsen Getty will implement an appropriate procedure to isolate such person from making decisions relating to the company's securities.

4. Belsen Getty principals Deru and Limpert served on the boards or were officers of a number of public companies, including Nine Mile, ProFire, and Prime Resource. Belsen Getty never placed those companies' securities or any others on a restricted list or watch list and never implemented an isolation procedure for any company, although Belsen Getty principals and employees served on the boards of those companies and possessed inside information about the companies. Deru, as Chief Compliance Officer, and Limpert, as a principal of Belsen Getty, failed to enforce the Code of Ethics, even though they were fully aware of the requirements and were aware that Belsen Getty principals and employees served as directors of public companies and possessed inside information.

5. Belsen Getty does not have adequate policies and procedures in place and, through Deru and Limpert, did not enforce its own policies and procedures. The policies did not adequately address conflicts of interest and did not have procedures in place to inform clients of conflicts. Because these policies were not in place, clients did not receive adequate disclosure about conflicts and whether their investment adviser was providing disinterested investment advisory services. Furthermore, contrary to Belsen Getty's policies and procedures, Belsen Getty, Deru, and Limpert often placed their own interests ahead of Belsen Getty clients and did not make adequate disclosures regarding investment recommendations. As principals of Belsen Getty, Deru and Limpert were responsible for complying with the Advisers Act and Belsen Getty's Code of Ethics, but failed to do so.

6. Deru and Limpert knew or were reckless in not knowing that Belsen Getty's policies and procedures were inadequate and unenforced. Deru and Limpert knew or were reckless in not knowing that their acts or omissions would contribute to Belsen Getty's failure to design, maintain and enforce written insider trading policies, a Code of Ethics, and procedures reasonably designed to prevent violation of the Advisers Act.

G. VIOLATIONS

1. 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.

2. As a result of the conduct described above, Belsen Getty willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser registered with the Commission. As a result of the conduct described above, Deru and Limpert willfully violated Sections 206(1) and 206(2) of the Advisers Act and, in the alternative, willfully aided and abetted and caused Belsen Getty's violations of Sections 206(1) and 206(2) of the Advisers Act.

3. As a result of the conduct described above, Deru willfully violated Section 206(3) of the Advisers Act, which prohibits an investment adviser from acting as principal for his own account and knowingly selling any security to a client without disclosing in writing the capacity in which he is acting and obtaining the consent of the client prior to completion of the transaction.

4. As a result of the conduct described above, Belsen Getty willfully violated Section 206(4) of the Advisers Act, which prohibits an investment adviser registered with the Commission from engaging in any act, practice, or course of business which is fraudulent, and Rule 206(4)-7 promulgated thereunder, which requires that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder.

5. As a result of the conduct described above, Belsen Getty willfully violated Section 204A of the Advisers Act and Rule 204A-1 thereunder, which require investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the investment adviser and associated persons.

6. As a result of the conduct described above, Belsen Getty willfully violated Section 204(a) of the Advisers Act, and Rule 204-2(a) promulgated thereunder, which require that investment advisers registered with the Commission maintain and preserve certain books and records. Rule 204-2(a) requires registered investment advisers to maintain written communications related to "any recommendation made or proposed to be made and any advice given or proposed to be given," and "any receipt, disbursement or delivery of funds or securities."

7. As a result of the conduct described above, Belsen Getty and Deru willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

8. As a result of the conduct described above, Deru and Limpert willfully aided and abetted and caused Belsen Getty's violations of Section 204(a), 204A and 206(4) of the Advisers Act, and Rules 204-2(a), 204A-1 and 206(4)-7 promulgated 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 Deru and Limpert 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, and sanctions with respect to their participation in offerings of penny stock pursuant to Section 15(b)(6)(A) of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondent Belsen Getty 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;

D. What, if any, remedial action is appropriate in the public interest against Respondents Deru and Limpert 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;

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

F. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act Respondent Belsen Getty should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 204(a), 204A, 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rules 204-2(a), 204A-1 and 206(4)-7 thereunder and whether Respondent should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act;

G. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act Respondent Deru should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1) and 206(2), 206(3) and 207 of the Advisers Act and from causing violations of and any future violations of Sections 204(a), 204A, and 206(4) of the Advisers Act and Rules 204-2(a), 204A-1 and 206(4)-7 thereunder and whether Deru should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act; and

H. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act Respondent Limpert should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and from Sections 206(1) and 206(2) of the Advisers Act, and from causing violations of any future violations of Sections 204(a), 204A and 206(4) of the Advisers Act and Rules 204-2(a), 204A-1 and 206(4)-7 thereunder and whether Limpert should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act.

**IV.**

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

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

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

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

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

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

By the Commission.

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. 64575 / May 31, 2011**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 3213 / May 31, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14407**

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| **In the Matter of**<br><br>**LARRY FEINBLUM,**<br><br>**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 203(f) OF THE INVESTMENT ADVISERS ACT OF 1040, 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 proceedings 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 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Larry Feinblum ("Feinblum" 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 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

## III.

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

## Summary

These proceedings arise out of the fraudulent conduct of Respondent and Jennifer Kim ("Kim"), his direct report, two traders at Morgan Stanley & Co., Inc. ("MS & Co." or the "firm"), that had the effect of concealing from risk managers the extent of the risk associated with their proprietary trading and that ultimately contributed to millions of dollars of losses in their trading books. From at least October through December 2009, Feinblum and Kim executed numerous trades in certain securities that they traded for MS & Co. that created net risk positions substantially in excess of limits that could be exceeded only with supervisory approval. To conceal from the firm that their trading exceeded internal net risk position limitations (the "excessions"), Feinblum (an Executive Director and Kim's supervisor) and Kim entered in MS & Co.'s risk management system swap orders -- on at least thirty-two occasions -- that they had no intention of executing and that they promptly canceled after entering the orders in the system. Feinblum and Kim entered those orders for the sole purpose of temporarily and artificially reducing the net risk positions in the securities, as recorded in certain of the firm's risk management systems, in order to pursue a strategy that sought to profit from price differences between U.S. and foreign markets. Feinblum and Kim cancelled the swap orders after they knew that the risk management systems had captured false and misleading information about their net risk positions and continued to execute their arbitrage trading strategy at positions beyond certain of MS & Co.'s net risk limits. As a result of Feinblum's and Kim's misconduct, MS & Co. unwound the unauthorized trading positions, ultimately sustaining a loss of approximately $24.47 million.

## Respondent

1. **Feinblum**, age 35, is a resident of New York, N.Y. From May 1999, until his termination effective January 4, 2010, Respondent was associated as a trader with MS & Co., which is dually registered with the Commission as a broker-dealer and as an investment adviser. At termination, Respondent was an Executive Director and a supervisor of the Equity Financing Products Swaps Desk ("Swaps Desk"), where he headed the desk's principal financing strategy and executed his arbitrage trading strategy. Feinblum was the immediate supervisor of Kim, a trader on the Swaps Desk. During the relevant period, Respondent held Series 3, 7, 24, 55, and 63 licenses.

[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.

## Relevant Individual and Entity

2. **Kim,** age 31, is a Canadian citizen who may reside in New York, N.Y., or Canada. Kim was associated with MS & Co. from August 2006, until her termination on January 4, 2010. At termination, Kim was a Financial Associate assigned to the Swaps Desk. Kim reported directly to Feinblum. Kim managed her own trading account as well as the MS & Co. proprietary trading account that Feinblum traded, executing and booking trades and acting as the risk manager for both accounts. During the relevant period, Kim held Series 3, 7, 55, and 63 licenses.

3. **MS & Co.** is a Delaware corporation with its principal place of business in New York, N.Y. It is a wholly-owned subsidiary of Morgan Stanley, the global investment bank. MS & Co. is dually registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act and as an investment adviser pursuant to Section 203(a) of the Advisers Act. MS & Co. conducts global equity sales and trading in part, through its Trade Desk. During the relevant period, the Trade Desk facilitated, as principal, emerging market structured product trading with customers. The Trade Desk also entered financing and index arbitrage transactions as principal while sourcing potential inventory for customer or other financing transactions. The Swaps Desk, part of the Trade Desk, conducted customer equity swap trading, principal financing and index arbitrage trading.

## Background

### A. The Swaps Desk

4. Feinblum began working for MS & Co. in 1999. In 2009, the firm assigned him to head the Swaps Desk's principal financing strategy where he supervised as many as seven other traders, including Kim. As Kim's supervisor, Feinblum trained Kim in the functions of the Swaps Desk in general, and with respect to the arbitrage trading strategy (described below). Feinblum could monitor Kim's trading in real time, as well as the trading of the other traders he supervised.

5. During the relevant period, Respondent supervised or was responsible for trading in over 600 accounts that held, or were authorized to hold, a variety of instruments including, but not limited to, American Depositary Receipts ("ADRs"), equity swaps and Exchange Traded Funds ("ETFs"). Respondent also was responsible for executing an arbitrage trading strategy that sought to profit by shorting ADRs (traded in U.S. markets), while taking a long position in the related common stock (traded overnight in certain Asian markets). The strategy was profitable overall and MS & Co. authorized and supported it.

### B. Risk Management Processes

6. As part of its overall risk management system, MS & Co. had risk limits for each trader and for the trading desk where the trader was assigned. During the trading day, MS & Co. electronically monitored on a real time basis the risk positions of each trader's accounts.

Shortly after the close of U.S. markets, MS & Co. required its traders to review and verify an end-of-day summary of the individual trader's positions. After they verified their positions, MS & Co. required traders to certify those positions in the firm's risk system, known as "ER," and the firm essentially took a 'snap shot' of positions as reported and certified. On trade date plus one ("T+1"), ER notified the trader's supervisor if a trader had exceeded the risk limits or that the trader had failed to certify as required.

7. During the relevant period, either Feinblum or Kim verified and certified to ER the positions in the accounts that each traded. As Kim's supervisor, Feinblum had the authority to approve any excessions to desk limits caused by Kim's positions. Similarly, Feinblum, his supervisors, and other members of senior management could approve excessions in Feinblum's accounts. In that regard, Feinblum essentially served a critical control position not only for traders under his supervision but also for his own trading account. Although Feinblum had authority to approve such excessions, it remained incumbent upon him to report his positions in the risk management system accurately to ensure that MS & Co.'s Risk Management Group ("Risk Management") and other supervisors knew of any such excessions.

8. MS & Co. used another control to report and to manage risk on a firm-wide basis. The firm consolidated information from ER and fed that information to a proprietary system that notified Risk Management on T+1 if it detected a risk excession, and identified the specific trade desk, the securities involved, and the related traders whose risk positions contributed materially to the excession. If Risk Management determined the risk unacceptable, it would direct the trader to reduce the risk to appropriate levels. Where appropriate, supervisors could authorize risk excessions and Risk Management could increase the risk limits.

## C. <u>The Swap Transactions</u>

9. As part of their trading and hedging strategy, Feinblum and Kim generally traded equity swaps -- synthetic agreements to buy or sell economic exposure (risk) to particular shares. MS & Co. had pre-arranged agreements with a counterparty to take contra-positions pursuant to a "Master Agreement." During the relevant period, Feinblum and Kim executed real swap transactions for two emerging market securities, Wipro Limited ("Wipro") and United Microelectronics Corp. ("UMC") pursuant to the Master Agreement and in two ETF baskets.[2] Feinblum and Kim used the same Master Agreement to enter swap transactions that they intended to cancel almost immediately, which had the effect of tricking MS & Co.'s risk management systems into recording reduced net risk positions, below MS & Co.'s limits. The two traders knew that the system recognized the fake trades as real.

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2 Wipro is an India-based provider of internet technology services. Its ADRs trade on the NYSE and its common stock trades on the Bombay Stock Exchange and the National Stock Exchange of India. UMC is a global semiconductor manufacturer based in the Republic of China that provides advanced technology and manufacturing services. Its ADRs trade on the NYSE and its common stock trades on the Taiwan Stock Exchange. Both ETFs (MSCI Emerging Markets Index and MSCI South Korea Index) trade on the NYSE.

**D. Execution of Feinblum's Trading Strategy**

10. Feinblum and Kim executed an arbitrage strategy that sought to profit from differences between the prices of ADRs and common stock. Respondent's strategy, specifically, was to sell short ADRs of the two emerging market securities, Wipro and UMC, and hold the common stock long, effectively hedging the two positions against each other. The ADRs in both securities had limited supply available to trade, compared to the number of common shares, and generally the ADRs traded at a significant premium. Respondent believed, however, that this premium would in time collapse due to a number of potential reasons, chief among them that Wipro and UMC eventually would increase the supply of ADRs in U.S. markets. Therefore, Respondent amassed significant short positions in the ADRs, hoping to profit when the price of the ADRs eventually dropped. On the long side of the trade, Respondent believed that with the availability of new ADRs, the price of the common stock, which was low, would increase. Therefore, he maintained a long position in the common stock, expecting to profit from selling the common stock at a higher price. MS & Co. approved of Feinblum's overall strategy with respect to Wipro and UMC.

11. By September 2009, however, Feinblum's and Kim's net risk positions in the proprietary accounts in Wipro, and to a lesser extent UMC, began to increase. Several factors played a part in increasing these net risk positions. First, Respondent continued shorting the ADRs, but did not increase his long position in the related common stock at a sufficient rate, so that his overall risk position in these securities was no longer net flat. Second, the exchange rates (the value of the local currency to the U.S. dollar) were increasing. Third, while the prices of both the ADRs and the common stocks were increasing, the price of the ADRs continued to increase at a rate faster than that of the common stock. As a result of these conditions, the price disparity between the levels of the ADRs and common stock continued to rise, increasing the accounts' net risk positions in each of the two securities and negatively impacting the hedge on these two securities.

**E. Feinblum's Misconduct**

12. On or about September 28, 2009, one of Respondent's supervisors spoke to him about the nature and size of his net risk position in Wipro. At the time that position was U.S. $20 million. The supervisor told Respondent not to increase the size of the net risk position unless he had significant conviction about the position and had discussed it with the supervisor first. Nevertheless, over the following week, Feinblum and Kim increased the net risk position in Wipro in these accounts. By October 6, 2009, the firm's net aggregate risk position in Wipro had exceeded the limit -- U.S. $50 million -- that the firm had placed on any single name emerging market security. A member of Risk Management informed Kim that the accounts she and Feinblum traded -- which were aggregated with proprietary positions of other traders in computing the firm's net risk positions -- had caused the firm to breach the U.S. $50 million net limit with respect to a single-name security, and that they needed to reduce their net risk position in Wipro. Kim notified Feinblum and, as directed, they brought their net risk position in Wipro down so that the firm's aggregate net risk position in Wipro was within the firm's limit.

13. Around the beginning of November, Feinblum's and Kim's net risk position in Wipro increased to U.S. $30 million ($10 million more than it was approximately one month earlier). Rather than discussing an increase of the risk limits with his supervisor as Respondent could have done, Respondent, acting with Kim, continued to increase their net risk position in Wipro, but Respondent and Kim devised a deceptive method to make it appear as though they were staying within MS & Co.'s risk limits. Specifically, on thirty-two separate occasions between October and December 2009, Respondent and/or Kim entered swaps with respect to Wipro and/or UMC -- sometimes doing so on consecutive days. Kim booked the swaps expressly to artificially reduce the book's net risk position with respect to Wipro and/or UMC so that it remained under the limit. Kim then falsely verified and certified the position in ER. Minutes later Kim cancelled the swaps, effectively returning the risk level to its true position on the security. Neither Respondent nor Kim requested or filled any orders for these swaps. While engaged in this conduct, Respondent misrepresented to Risk Management that he had reduced his net risk position in Wipro and that his objective was to continue to reduce his net risk position in Wipro as the prices of the ADRs and common stock converged. In fact, however, Respondent and Kim continued to increase the Wipro net risk position.

14. In early December, unrelated to these events, MS & Co. reallocated certain proprietary accounts from Kim to Feinblum. The two traders modified their method of recording trades in the ER in order to artificially reduce the risk across both of their books. Typically, one of the two books held most of the risk, while the other did not. Feinblum and Kim booked a swap between the two books, specifically from the book holding the higher risk position, to the other book, thereby artificially reducing the risk position in the first book. The two traders then published the reduced position for the first book to ER, certified that position, and then minutes later cancelled that swap. The cancellation had the effect of moving the risk back to the first book, where it belonged, and reducing the risk in the second book to its true position. Feinblum and Kim then published the second book's risk to ER and certified the risk position. The two booked the fake swaps only to reduce the books' risk positions in ER.

## F. The Misconduct is Exposed

15. Respondent's and Kim's deceptive entries in the ER system came to light between December 15 and 16, 2009, when the market moved against Feinblum's positions. By close of the market on December 16, Respondent's trade book recorded a significant notional loss. When Respondent left work, he told his supervisor that he had lost $7 million that day. The next morning, Respondent admitted to the supervisor that he and Kim had exceeded the risk limits repeatedly over the relevant period and had concealed such excessions as described above. Based on his misconduct, MS & Co. terminated Respondent.

16. As a result of the conduct described above, Respondent 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 or security-based swap agreements.

## IV.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Section 203(f) of the Advisers Act it is hereby ORDERED that:

A. Respondent Feinblum 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 Feinblum 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, 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 $150,000 to the United States Treasury. Payment shall be made in the following installments: $50,000 within thirty (30) days of the entry of this Order, $25,000 within ninety (90) days of the entry of this Order, $25,000 within one-hundred eighty (180) days of the entry of this Order, $25,000 within two-hundred seventy (270) days, and $25,000 within three-hundred sixty (360) days of the entry of this Order. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, 100 F Street, N.E., Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Larry Feinblum 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 Ken C. Joseph, Assistant Director, Division of Enforcement, New York Regional Office, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, New York 10281.

By the Commission.

Elizabeth M. Murphy
Secretary

Cathy H Ahn

By: Cathy Ahn
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64573 / May 31, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14405

| In the Matter of<br><br>Delcott Commodity Partners,<br>Delta-Omega Technologies, Inc.,<br>DeVlieg-Bullard, Inc.,<br>Digital Recording Corp.,<br>Diversified Realty, Inc.,<br>Double River Oil & Gas Co., and<br>Drypers Corp.,<br><br>Respondents. | ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934 |
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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 Delcott Commodity Partners, Delta-Omega Technologies, Inc., DeVlieg-Bullard, Inc., Digital Recording Corp., Diversified Realty, Inc., Double River Oil & Gas Co., and Drypers Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Delcott Commodity Partners (CIK No. 716933) is a terminated Tennessee limited partnership located in Memphis, Tennessee with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Delcott Commodity is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 1993, which reported a net loss of over $62,000 for the prior twelve months.

2. Delta-Omega Technologies, Inc. (CIK No. 846978) is a Colorado corporation located in Broussard, Louisiana with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Delta-Omega Technologies 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 November 30, 2001, which reported a net loss of over $123,000 for the prior three months. On March 2, 2006, the company filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Louisiana, and the case was terminated on March 6, 2007.

3. DeVlieg-Bullard, Inc. (CIK No. 858710) is a void Delaware corporation located in Rockford, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DeVlieg-Bullard is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended April 30, 1999, which reported a net loss of over $8.8 million for the prior nine months. On July 15, 1999, DeVlieg-Bullard filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Ohio, and the case was terminated on January 20, 2010.

4. Digital Recording Corp. (CIK No. 318439) is a forfeited Delaware corporation located in Levelland, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Digital Recording 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 $24,000 for the prior nine months.

5. Diversified Realty, Inc. (CIK No. 29258) is a Montana corporation located in Great Falls, Montana with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Diversified Realty is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2004.

6. Double River Oil & Gas Co. (CIK No. 351400) is a forfeited Texas corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Double River Oil & Gas 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, 1996, which reported a net loss of $29,000 for the prior nine months.

7. Drypers Corp. (CIK No. 894232) is a dissolved Delaware corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Drypers is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2000, which reported a net loss of over $36.8 million for the prior nine months. On October, 10, 2000, Drypers filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Texas, and the case was terminated on December 23, 2004.

B. DELINQUENT PERIODIC FILINGS

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

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

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

**III.**

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

A. Whether the allegations contained in Section II 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. 64574 / May 31, 2011**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-14406**

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| **In the Matter of**<br><br>**Sanctuary Woods Multimedia Corp., Satellite Auction Network, Inc. (a/k/a, L International Computers, Inc.), Scientific Measurement Systems, Inc., Scorpion Technologies, Inc., Scott Science & Technology, Inc., Security Environmental Systems, Inc., and Sensotron, Inc.,**<br><br>**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 Sanctuary Woods Multimedia Corp., Satellite Auction Network, Inc. (a/k/a L International Computers, Inc.), Scientific Measurement Systems, Inc., Scorpion Technologies, Inc., Scott Science & Technology, Inc., Security Environmental Systems, Inc., and Sensotron, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Sanctuary Woods Multimedia Corp. (CIK No. 900748) is a void Delaware corporation located in Emeryville, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sanctuary Woods is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it

filed a Form 10-K for the period ended March 31, 1998, which reported a loss of over $16.5 million for the prior twelve months. On July 6, 1999, Sanctuary Woods filed a Chapter 7 petition with the U.S. Bankruptcy Court for the Northern District of California, which was terminated on February 1, 2006.

2. Satellite Auction Network, Inc. (a/k/a L International Computers, Inc.) (CIK No. 803571) is a void Delaware corporation located in Irving, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Satellite Auction is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended April 30, 1987, which reported a net loss of over $730,000 for the prior three months. It appears that Satellite Auction's corporate identity was highjacked by L International Computers, Inc., which is not a legitimate corporate successor. Based on this apparent corporate identity theft, on March 13, 2008, the Commission suspended trading in the securities of L International Computers (symbol "LITL") due to a lack of current and accurate information concerning its securities.

3. Scientific Measurement Systems, Inc. (CIK No. 87814) is a forfeited Texas corporation located in Austin, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Scientific Measurement Systems 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 $329,000 for the prior three months. On December 13, 2000, Scientific Measurement Systems filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Western District of Texas, and the case was terminated on September 12, 2003.

4. Scorpion Technologies, Inc. (CIK No. 803190) is a Colorado corporation located in San Jose, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Scorpion Technologies 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 $7.3 million for the prior nine months.

5. Scott Science & Technology, Inc. (CIK No. 735635) 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). Scott Science & Technology is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended September 30, 1996.

6. Security Environmental Systems, Inc. (CIK No. 842399) is a void Delaware corporation located in Huntington Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Security Environmental 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 March 31, 1994, which reported a net loss of over $562,000 for the prior three months. On April 20, 1995, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Central District of California, and the case was terminated on August 9, 2000.

7. Sensotron, Inc. (CIK No. 826757) is a suspended California corporation located in Huntington Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sensotron is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K/A for the period ended August 31, 1995, which reported a net loss of over $1.4 million for the prior twelve months.

B. DELINQUENT PERIODIC FILINGS

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

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

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

## III.

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

A. Whether the allegations contained in Section II 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